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on Innovation and U.S. Competitiveness*

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Living with the Trade Deficit: Adjustment Strategies to Preserve Free Trade

*Robert Z. Lawrence
and
Robert E. Litan*

SUPPORTERS of free trade are on the defensive. A rising trade deficit — threatening to top \$150 billion this year — and sluggish economic growth have encouraged the introduction of more than 300 bills in Congress to restrict access by foreign goods to the U.S. market. Unless the trade gap narrows, the prospects are good that some type of protectionist legislation will be enacted before the 1986 mid-term congressional elections.

Most economists decry this apparent drift toward protectionism. They tirelessly point out that the primary reason for the high and rising trade deficit is the succession of record federal budget deficits, not the barriers to trade maintained by other nations (see box). After all, they reason, the trading system is no more unfair to the United States today than it was in 1981 when the United States enjoyed a positive trade balance in manufactured goods.

At the same time, however, there is growing concern among both politicians and economists about the long-range implications of the current trade imbalance. Last spring, the United States became a net debtor nation for the first time since 1914, largely as a result of unprecedentedly high borrowing from foreign creditors who help to finance the growing trade deficit. Continued increases in debt owed to foreign nations will ultimately be paid for by sacrifices in future living standards, through shipments to foreign purchasers of U.S.-produced goods that American consumers would otherwise enjoy. If this debt repayment is attended by a substantial depreciation of the dollar — which many economists believe is inevitable — the cost of imported goods will climb and the rate of inflation will increase.

Erecting trade barriers here, either as bargaining chips or as purely protectionist devices, would only make matters worse. Added trade restrictions would strengthen the dollar and reduce the competitiveness of American goods in world markets. Also, a turn toward protectionism by the United States could trigger retaliation by other countries, leaving all trading nations worse off, as occurred in the 1930s after the United States passed the infamous Smoot-Hawley Tariff Act. Finally, curtailing imports from countries now heavily in debt, such as Brazil and South Korea, could strain the American banks to which this debt is owed and threaten the viability of an already fragile financial system.

Many of the new congressional advocates of protection are cognizant of its dangers, but argue that protectionist measures are needed to close the worsening trade gap. One cynical explanation is that lawmakers are using the growing trade deficit to make foreign countries the scapegoats for the recent hiatus in the U.S. economic recovery. A more compelling explanation is that lashing out at foreign trade barriers can be more attractive politically than tackling the complex and divisive task of reducing the principal cause of the current trade imbalance: the federal budget deficit, which most forecasters outside the administration expect

Robert Z. Lawrence and Robert E. Litan are senior fellows in the Economic Studies program at Brookings and are working with Robert W. Crandall, also of Brookings, on a book about adjustment policies. The authors gratefully acknowledge funding from the Ford Foundation.

“Rather than acceding to protectionism, lawmakers should develop effective policies for easing the dislocations induced by trade. . . . Put in economic terms, aid for trade-injured parties can reduce both the demands for protection and the willingness of elected leaders to supply it.”

to exceed \$100 billion a year through the end of the decade.

In such an environment, repeated calls by economists, the news media, and other opinion leaders for budget discipline as a means of paring the trade deficit are likely to fall on deaf ears in Congress, which is pressured continually by workers and firms in trade-sensitive sectors of the economy that have been battered by the strong dollar. To be sure, the dollar has weakened somewhat in the wake of the Treasury Department's recent commitment to intervene with the finance ministries of Japan, England, France, and West Germany in foreign exchange markets. In addition, the political momentum behind protectionism abated somewhat following the administration's announcement of its intention to step up enforcement of the laws against unfair trade practices. Nevertheless, the political impulses to embrace protectionist remedies remain strong. They will continue to push the administration away from policies favoring freer trade; even more dangerously, they could lead to concrete protectionist actions should U.S. economic growth continue to stall or the economy slide into recession.

Rather than acceding to protectionism, lawmakers should develop effective policies for *easing the dislocations induced by trade*. Politicians continue to face pressures for protectionism from firms, workers, and communities adversely affected by import competition; lawmakers can and will find it difficult to resist calls for trade barriers if they cannot point to policies that mitigate the economic pain

caused by changes in trade patterns. Put in economic terms, aid for trade-injured parties can reduce both the demands for protection and the willingness of elected leaders to supply it.

The United States has attempted in the past to provide such assistance, but with mixed success. We believe that the nation can do better, but only if programs are designed to promote, rather than delay, adjustment to change. The cruelest form of aid is one that temporarily salves an economic wound, but that, in the end, leaves recipients in even worse shape to deal with the harsh competitive realities of the global marketplace. The danger of this outcome can be reduced if trade assistance programs meet the following criteria:

- Assistance must be temporary, so that it does not encourage dependence.
- Assistance must be transparent, so that voters and politicians are aware of its costs.
- Assistance must complement, rather than replace, market forces.

Below we present several detailed proposals based on these criteria. In part, our suggestions envision a fundamental redirection of two programs already in place: the temporary protection available through the current U.S. “escape clause” law and the help provided to some workers under the trade adjustment assistance program. Under our proposals, two types of aid would be triggered by an International Trade Commission (ITC) determination that an industry is suffering serious injury because of import competition. First, firms in the industry would be eligible for temporary protection from imports in the form of tariffs, but not quotas. Mergers of such firms would be judged under antitrust standards that recognize global competition. Second, workers in the industry would be eligible automatically for payments geared to their losses in income and for loans to finance retraining, with repayments based on future income and collected through the income tax system. We conclude by outlining a novel plan, not tied to ITC determinations, for enabling communities to insure against sudden losses in their tax bases due to trade-related or other economic dislocations.

Assisting Adjustment by Industry

Special assistance programs for industries adversely affected by import competition are considered justified on economic grounds in two circumstances. First, when changes in trade patterns reflect fundamental shifts in comparative advantage, targeted industry assistance can cushion the economic pain suffered by firms, their workers, and the communities in which they are located. Second, when a sudden surge of import competition is due to temporary factors, industry aid can prevent or minimize unnecessary losses in physical and human capital. For example, a nation may have a long-run comparative advantage in producing high-quality shoes or clothing. However, due to sudden relaxations in trade barriers or movements in exchange rates, its footwear and clothing industries may be temporarily unable to compete effectively with foreign producers. Without some short-term assistance to tide them over, firms in these industries can be severely and permanently damaged, large capital investments destroyed, and a trained labor pool lost forever.

The Current Assistance Program

In recognition of the potential value of assistance in the above circumstances, the United States and other nations allow temporary protection of domestic industries. The General Agreement on Tariffs and Trade (GATT), currently signed by over 80 nations, permits member countries to "escape" temporarily from tariff concessions and other obligations under the agreement if, as a result of such concessions, imports threaten or cause serious injury to domestic producers.

The U.S. escape clause law, set forth in sections 201 through 203 of the Trade Act of 1974, allows relief for up to five years if domestic industries can demonstrate to the ITC that they face serious harm from import competition. (This law is more liberal than the GATT because it permits temporary protection even if the harm to the domestic industry is not a result of the removal of trade barriers under the GATT.) Import protection is not automatic, however. Even when the ITC finds the requisite serious injury, the president has substantial discretion: He may impose tariffs or quotas; negotiate orderly marketing agreements (OMAs), which are in effect bilateral quotas; recommend expeditious consideration of worker requests for adjustment assistance; or grant no relief at all.

The principal advantage of the escape clause is that it establishes an administrative mechanism that removes pleas for protection from the domain of elected officials. The clause has been fairly successful at keeping protection temporary. Of the 30 industries that have received protection in Section 201 cases since 1950, only two—motorcycles and specialty steel—remain protected today. By contrast, protections obtained directly from the Congress or through country-to-country agreements (as in the case of quotas for imports of textiles, beef, and sugar) have as a practical matter been permanent. Indeed, it is unfortunate that Congress has not required the ITC to provide regular reports on the impacts of these measures on consumers, firms, and workers. Such reports would at least expose to public view the costs and benefits of continued protectionism—and Congress should provide for them if it decides to give permanent quota protection to the textile, footwear, and other domestic industries.

Criticisms of the Current System and Some Proposals for Change

The escape clause mechanism, however, is an imperfect method for assisting adjustment by trade-injured firms. Experience with other kinds of trade restraint suggests that protectionism, even if it is temporary, is expensive because it raises prices of all products—both foreign and domestic—in a protected market. Susan Hickok of the Federal Reserve Bank of New York estimates that current U.S. trade barriers are costing consumers at least \$14 billion per year. Our colleague, Robert Crandall, has calculated that one barrier—the so-called "Voluntary Restraint Agreement" that limited exports of Japanese automobiles to the United States—alone cost American consumers over \$4 billion annually in higher prices, until the arrangement was allowed to expire earlier this year. According to Crandall, the cost per job saved in the automobile industry was \$160,000 per year—more than four times the average annual compensation of auto workers!

Not surprisingly, therefore, most economists urge that if trade-related assistance is to be provided at all to industry, it take the form of direct subsidies. In principle, subsidies are more efficient than tariffs or quotas because they do not distort the relative prices of goods and, therefore, do not disturb consumption patterns. However, in the current budget climate, it is unrealistic to expect Congress to adopt this "first-best" solution. Moreover, it is questionable whether direct subsidies allotted through the political process would be as efficient as is often thought. In theory, subsidies should be allocated to those firms offering the highest prospective returns. In practice, the political process tends to allocate subsidies on bases other than pure economic criteria.

Of course, the design of a non-subsidy protection program presents its own set of difficulties. One challenge is to ensure that any protection granted is cost-effective. This goal can be realized only if the form of protection promotes rather than delays adjustment; otherwise, society will be forced to suffer the pain of higher prices without reaping the benefits that protection is designed to achieve.

A second challenge is to avoid making protection either too easy or too difficult to obtain. If it is too readily granted, protection will be awarded in many instances in which it is not appropriate, producing unnecessary costs for consumers. On the other hand, if escape clause relief is rarely forthcoming, domestic industries and their workers will seek other, perhaps more lasting and invidious forms of protection directly from the Congress. For example, President Reagan's decision in September, 1985, to reject the ITC's recommendation that the U.S. shoe industry receive temporary import protection is widely credited with intensifying protectionist sentiment in Congress. The result could be legislated protection, for years to come, of the U.S. shoe industry and other domestic industries; this would be far more costly to consumers than the declining quotas for

"One challenge is to ensure that any protection granted is cost-effective. This goal can be realized only if the form of protection promotes rather than delays adjustment; otherwise, society will be forced to suffer the pain of higher prices without reaping the benefits that protection is designed to achieve."

The Link Between Federal Budget Deficits and Trade Deficits

THE U.S. current account — the net balance of exports and imports of goods and services — can be directly linked to the U.S. budget deficit. This is because the current account balance is, by definition, equal to the difference between national saving and national investment. At any given level of employment, if the government seeks to increase its consumption, either the private sector will have to consume less or the goods will have to be obtained from abroad. Thus, given private investment and savings behavior, an increase in the government deficit will translate, dollar for dollar, into a decline in the current account balance. This means the size of the current account balance is not so much an indicator of a nation's competitiveness as it is of the nation's spending behavior.

These principles can be derived algebraically from the definitions of Gross National Product (GNP) and Gross National Income (GNI), which must be identical. GNP is the sum of Private Consumption (C), Private Investment (I), Government Spending (G), Exports of Goods and Services (X), minus Imports of Goods and Services (M), or

$$\text{GNP} = C + I + G + X - M.$$

GNI, meanwhile, equals the sum of Private Consumption (C), Private Saving (S), and Tax Revenues of the Government (T), or

$$\text{GNI} = C + S + T.$$

Since GNP must equal GNI, the above two identities can be set equal to each other, as follows:

$$C + S + T = C + I + G + X - M.$$

After subtracting C from each side, these terms can be rearranged into the following fundamental identity:

$$(S - I) + (T - G) = X - M,$$

or Net Private Saving + Net Government Saving = Current Account Balance.

In short, the current account balance equals the sum of net private and government saving. Figure 1 shows what has happened to each of the components of this identity since 1977. Significantly, the current account balance began to turn negative as the total government deficit (dissaving) began to rise. The current account balance has deteriorated most sharply since 1982, when net private saving dropped precipitously and the total government deficit was then exceeding 3 percent of GNP.

footwear imports recommended by the ITC.

Many members of Congress are dissatisfied with the current U.S. escape clause law, and a variety of proposals have been made to change it. Unfortunately, some of these could actually reduce the capability of the escape clause mechanism to meet the two challenges just discussed.

One class of proposals, for example, would weaken the current legal causation standards, by which the ITC determines whether an industry's poor economic health has been caused by import competition. These proposals are difficult to justify in light of experience under Section 201. Since the standards were last eased in the 1974 Trade Act, the ITC has found import-induced injury in 32 of the 55 cases in which petitions for escape clause relief have been filed — a "success" rate for domestic industries of almost 60 percent. Since some undeserving cases are now presented to the ITC, this proportion suggests that further relaxation of the causation test could yield an excessive degree of protection.

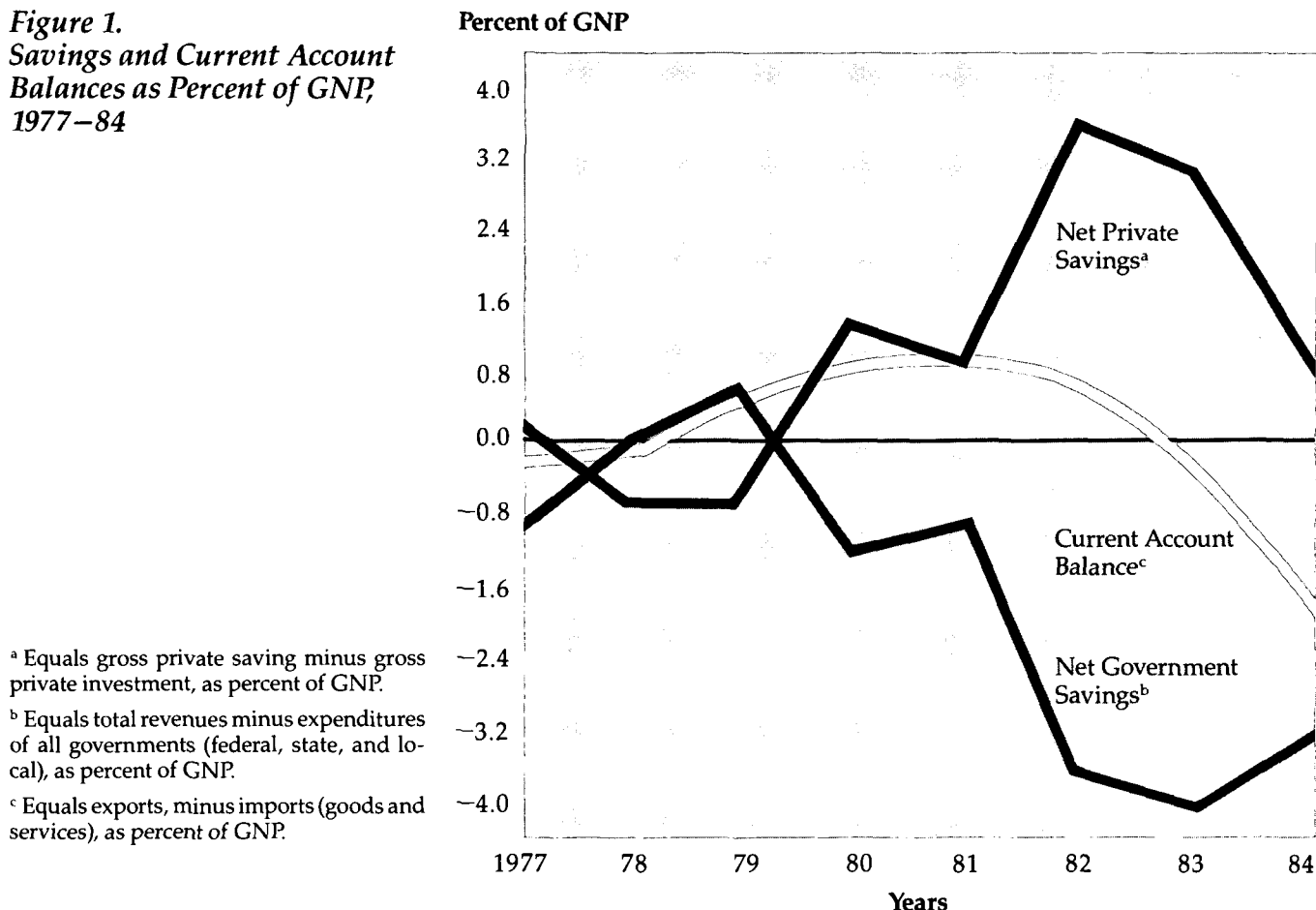
Another class of suggestions would make import relief conditional on commitments by domestic industries to modernize and reinvest. The model for this conditionality approach is the 1980 loan guarantee package for Chrysler, which Congress approved only after management and labor at the company agreed to a number of conditions on the firm's operations, including limits on employee compensation. Last year, Congress extended the conditionality con-

cept to the steel industry, which benefits from export restraint arrangements with other steel-exporting countries. In the 1984 Trade Act, Congress conditioned the continuation of these arrangements on an annual presidential certification that major U.S. steel companies are reinvesting all their net cash flow in the steel business.

However, the Chrysler analogy is inapposite to the trade context. It is one thing for a creditor, such as the U.S. government, to impose conditions on a single debtor as a price for receiving credit or other financial assistance. It is quite another thing for government, not acting as a creditor, to negotiate conditions for an entire industry. That process inevitably facilitates coordination by domestic competitors of investment plans, product strategies, and even pricing decisions. The result can be cartel-like behavior that is totally at odds with U.S. antitrust laws and inconsistent with the interests of American consumers.

Equally significant, the conditionality approach violates our criterion that trade relief not be permitted to replace market forces. Conditionality unjustifiably presumes that government officials possess knowledge or information superior to that of the private sector. However, as in the 1984 Trade Act's reinvestment requirements for the steel industry, the bias of government will always be toward the expansion and modernization of a trade-injured domestic industry. Economic reality often confutes that bias; trade difficulties generally signify a need for *exit* from an indus-

Figure 1.
Savings and Current Account
Balances as Percent of GNP,
1977–84



try, not for additional investment in it. Indeed, our analysis of a sample of 16 industries that received some type of import protection over the last two decades indicates that only one of them, the bicycle industry, increased its production and employment levels after protection was removed. The rest shrunk in size, although some were more successful than others in developing and introducing new products and technologies. Had the government required each of these industries to meet the kind of reinvestment conditions imposed on the steel industry in 1984, much investment would have been wasted.

A final class of proposed reforms stems from congressional criticism of how much discretion the current escape clause law allows the president once the ITC determines that import competition has seriously injured a domestic industry. Since 1975, the president has granted import relief in only 13 of the 32 cases in which the ITC has made an affirmative escape clause finding (although in five other instances, he has recommended expedited consideration of adjustment assistance for displaced workers). Given this record, some lawmakers have suggested the elimination of presidential discretion to accept or reject the ITC's import relief recommendations. Others have urged that the decision to impose import barriers be vested in the United States trade representative (USTR), subject to a presidential override. This proposal seems to assume that the USTR would be more likely than the president to grant import

relief once the ITC made an affirmative injury finding.

We favor some narrowing of presidential discretion under the escape clause procedure, but we do not support the proposals lawmakers have so far considered. Granting automatic import protection to industries found to be suffering from import-induced injury would run a dangerous risk of imposing too much protection. This would not only harm consumers, but damage relations with foreign trading partners. On the other hand, a transfer of import relief authority to the USTR would be unlikely to accomplish the objectives of its proponents, since the head of that office serves at the pleasure of and reports to the president.

Our Alternative Proposals

We recommend that the current law be changed in two respects. First, if the president decides to grant any import protection at all under the escape clause, he or she would be limited to imposing a four-year schedule of declining tariffs. In addition, all existing quotas (such as those on textiles, steel, beef, and sugar) would be replaced with tariffs set in advance to decline, but perhaps over periods longer than the five years provided for in the current escape clause. The first-year tariff levels would be established through auctions of quota rights.

Second, although the current legal standards for proving import-induced injury should remain intact, two compo-



Robert St. John

nents of relief should be triggered *automatically* upon an affirmative finding by the ITC. Workers in an affected industry who are laid off in the four years following the filing of a successful petition would become eligible for adjustment assistance (as described below). Revenues from any tariff imposed under the escape clause law would be earmarked to fund the assistance, with supplements from general appropriations as required. In addition, firms in an affected industry would be judged by proposed mergers involving antitrust standards that gauge competitive impacts in terms of the international market, rather than just the domestic one, provided that the industry is not benefit-

ing from import protection. A change of this sort, which the administration has also been considering, would make approval of such mergers more likely.

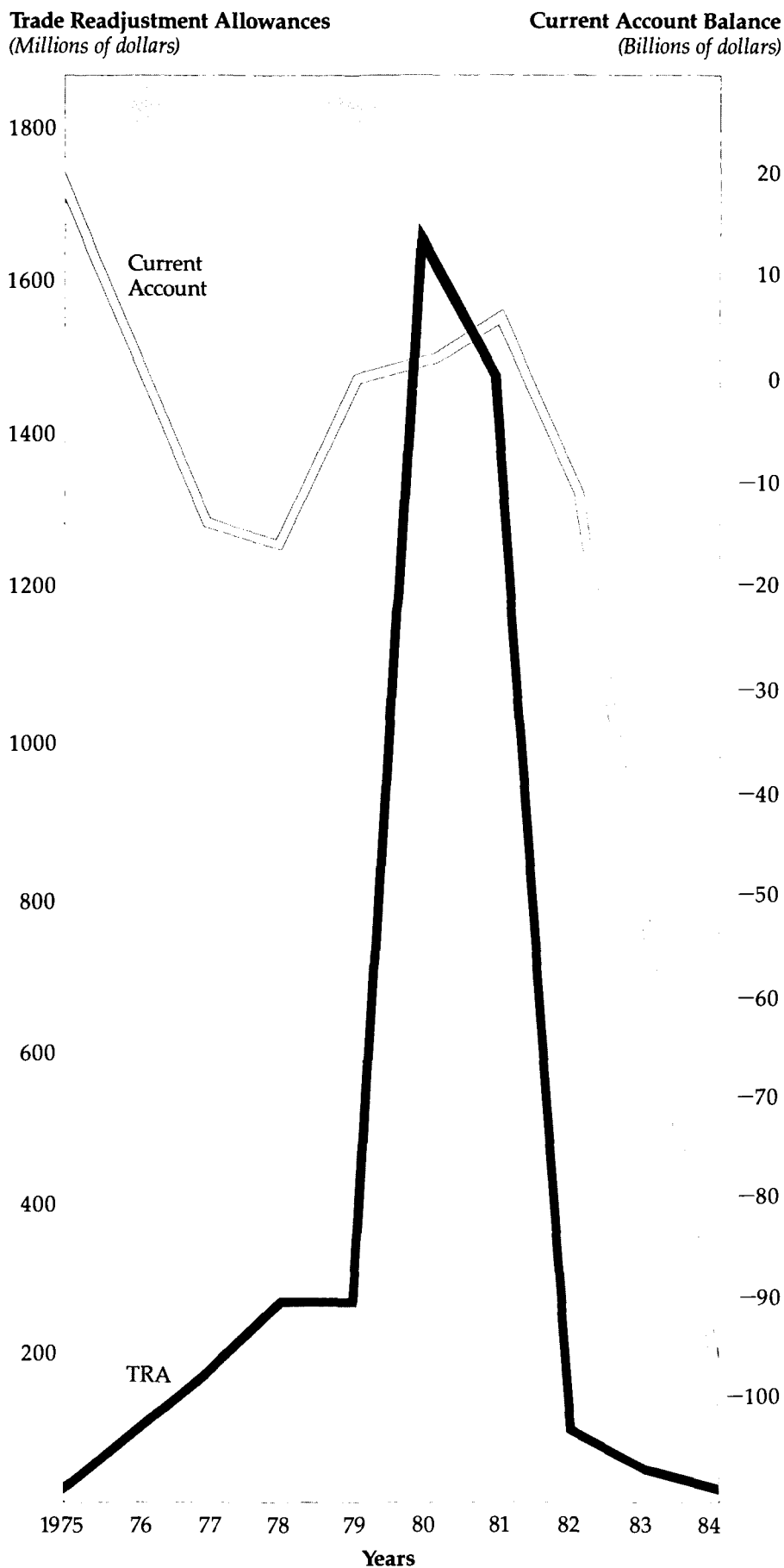
This plan has a number of advantages. Its first feature eliminates the least cost-effective means of providing temporary industry assistance: quotas or OMAs. Unlike tariffs, the costs of which are transparent to consumers and lawmakers, quotas pose hidden costs. Perhaps more important, they make it easier for domestic producers with market power to increase their prices. Tariffs penalize imports, but also allow them to enter freely and act as a competitive check on outsized price hikes. Moreover, tariffs yield additional revenue for the government; quotas do not.

The second aspect of the plan — the automatic relief components — should provide sufficient ammunition to lawmakers to fend off demands for legislated protection. In contrast with current law, which vests certification authority in the ITC for import relief and in the Labor Department for adjustment assistance, the proposed plan would make both kinds of relief contingent on a single proceeding. Workers adversely affected by trade would not have to wait for adjustment assistance, which in the past has often become available only after displaced workers have already found new employment.

Finally, the proposed revision of antitrust standards for mergers involving companies in impacted industries would be, compared to the present system, a more socially productive strategy for inducing such firms to seek Section 201 relief instead of legislated alternatives. Under current antitrust law, merger standards are relaxed only for specific failing companies, not for all firms in a particular industry, and, in fact, the criteria for qualifying as a failing company are rarely met. In addition, until recently government assessments of the competitive impact of proposed mergers have rarely taken foreign producers into account. Our proposal would force antitrust officials to recognize that firms

“Unlike tariffs, the costs of which are transparent to consumers and lawmakers, quotas pose hidden costs. Perhaps more important, they make it easier for domestic producers with market power to increase their prices.”

Figure 2.
Trade Readjustment
Allowances (TRAs) and
Current Account
Balance



Note: TRAs based on fiscal years, trade balance on calendar years.

Sources: Employment and Training Administration, Dept. of Labor, unpublished data; Economic Report of the President, Council of Economic Advisers, February, 1985; Economic Indicators, Council of Economic Advisers, August, 1985.

Table 1.
Trade Adjustment Assistance
Data, Fiscal Years 1977–84

	FY 1977–81	FY 1982–84
(1) Total number of workers receiving TRA benefits	1,211,206	76,316
(2) Total number of workers who entered retraining	46,504	23,876
(3) Worker retraining ratio (2)/(1)	3.84%	31.29%
(4) Total number of workers who completed retraining	16,926	11,055
(5) Retraining completion ratio (4)/(2)	36.40%	46.30%
(6) Total number of placements after retraining ^a	3,509	968
(7) Placement retraining ratio (7)/(2)	7.55%	4.05%

^a Placements, as a result of retraining, based upon specific job definitions used by state employment service agencies.

Source: Employment and Training Administration, Office of Trade Adjustment Assistance, Department of Labor.

meriting relief under the escape clause are competing in world markets in which, in all probability, fewer firms with less capacity can survive. We reject, however, the Commerce Department's proposal to exempt such firms from merger standards altogether. This could produce highly concentrated markets, to the detriment of consumers.

Our plan does raise one complication in light of the current GATT rules for escape clause actions, which require the United States and other signatories to compensate trading partners when erecting tariff barriers. We believe that this requirement should be suspended when protection results from a transparent legal process and takes the form of self-liquidating tariffs. An exception in these circumstances would be far more in keeping with the spirit of the GATT than the current compensation provisions, which, unfortunately, countries have avoided by resorting to discriminatory quota and voluntary export restraints that threaten to undermine market-based trade.

Assisting Adjustment by Workers

The Current Assistance Program

In principle, there is no reason why workers displaced as a result of import competition should be treated better than those dislocated because of other developments, such as technological improvements or shifts in demand patterns. Nevertheless, when it was first introduced in 1962, trade adjustment assistance for workers was justified as a means of compensating those adversely affected by tariff reductions. Currently, such assistance can be viewed as compensation for the more general dislocation costs of open trade. Presidents Ford and Carter, when subject to politically pressing demands for protection during election years, made effective use of trade adjustment assistance for affected workers. As shown in Figure 2, however, the Reagan administration has severely curtailed the most important component of trade adjustment assistance, Trade Readjust-

ment Allowances (TRAs), despite unprecedented trade pressures.

Unfortunately, defects in the design of the trade adjustment assistance program in recent years have obscured its potential usefulness as an anti-protectionist device. First, the manner in which TRA assistance has been provided has tended to discourage, rather than facilitate, worker adjustment. Congress recognized this problem in 1981 when it abandoned the previous TRA compensation system, which provided assistance to workers only during weeks in which they also collected unemployment insurance. Congress believed that this system encouraged displaced workers to stay home, rather than to seek new employment.

The new TRA compensation system, urged upon Congress by the Reagan administration and adopted in 1981, attempts to correct the incentive problem. Under the new system, trade-displaced workers not enrolled in retraining programs are eligible to collect TRA only after they have exhausted their unemployment compensation benefits. The period during which they get either type of aid may not exceed 52 weeks. For example, a worker who has received 39 weeks of unemployment compensation can then be eligible for no more than 13 weeks of TRA. (There is an exception to this rule: A worker can qualify for an additional 26 weeks of TRA payments by enrolling in a retraining program.)

The Reagan-era TRA program appears to have encouraged trade-displaced workers to pursue retraining, but not necessarily to search for and obtain new jobs. As shown in Table 1, the fraction of all workers receiving TRA benefits who entered retraining programs has increased sharply during the Reagan administration — from 3.8 percent in fiscal years 1976–81 to 31.3 percent in fiscal years 1982–84. However, while the proportion of workers who have finished retraining programs has also risen, the percentage actually obtaining jobs for which their retraining qualified them has fallen — from 7.6 to just 4.1 percent. These figures suggest that the TRA compensation system adopted in 1981 may have encouraged some workers to undertake retrain-

"These figures suggest that the TRA compensation system adopted in 1981 may have encouraged some workers to undertake retraining programs merely to continue collecting TRA benefits rather than searching for meaningful employment."

ing programs merely to continue collecting TRA benefits rather than searching for meaningful employment.

More generally, Table 1 indicates that, despite the incentives adopted by Congress in 1981, the preponderance of trade-displaced workers — 68 percent — have *not* sought retraining. These workers are simply not being encouraged to find work by the 1981 TRA compensation system, which tacks TRA payments onto the end of the unemployment compensation period.

The second problem with previous trade adjustment assistance programs is that the levels of compensation they have provided have borne a highly imperfect relationship to the economic losses that trade-displaced workers have actually sustained. In principle, those losses are equal to the total earnings missed due to unemployment plus the decline in earnings capacity in subsequent employment. For example, a steelworker who because of import competition is let go and must eventually accept a job as an auto mechanic loses not only income during unemployment, but also the value of his or her unutilized steel-making skills (including both forfeited "human capital" and accumulated seniority).

Current and previous TRA compensation formulas have taken account of only the first of these components of earnings loss. The pre-1981 compensation system, for example, provided TRA and unemployment compensation benefits totaling 70 percent of a worker's former gross weekly wage (but not more than the national average of weekly manufacturing wages), minus amounts received for retraining and 50 percent of part-time earnings. Since 1981, displaced workers have been entitled only to extended TRA benefits equal to previous unemployment compensation amounts, which are based roughly on a worker's prior earnings. Neither compensation formula has reflected declines in the earnings capacities of workers in subsequent employment. Two individuals who are unemployed for the same length of time may ultimately find new jobs paying vastly different wages, but under the present system both would receive the same amount of TRA.

Current Reform Efforts

At this writing, Congress is considering a reform bill, authored by Senator William V. Roth, Jr., that would only partially cure these defects. The Roth proposal would extend the maximum benefits period from 52 weeks to 78 weeks. It would require workers receiving benefits to be enrolled in, or to have completed, a training program funded by a \$4,000 job retraining voucher. Vouchers would be redeemable for training in a variety of programs, including those under the Job Training Partnership Act, those approved by the secretary of labor, and those conducted without federal support by private firms. The Roth plan would be financed by an across-the-board import fee of up to 1 percent; the precise level would be set by the president. Congressman Donald J. Pease has introduced a House bill similar to the Roth proposal.

Although the Roth-Pease approach makes a constructive effort to increase worker skills, it has several important flaws. First, it would force workers to enroll in retraining simply to obtain extended unemployment compensation, rather than because the retraining would be cost-effective. Training may be useful for some workers, but a waste of time for others. Indeed, the track record of the Reagan administration's TRA program, in which only 4.1 percent of workers were placed in jobs for which they were trained, points to the limitations of this approach. In our view, subsidized training should be an option available to displaced workers, but it should be neither mandatory nor free.

A second flaw in the Roth-Pease proposal is that by extending unemployment benefits but not compensating workers who find alternative employment, it would continue the subsidization of those who fail to seek new jobs. Finally, although the basic rationale for adjustment assistance is to compensate those hurt when trade is kept free, the Roth-Pease program would also perpetuate the error of granting benefits to workers even if the industry from which they are displaced is protected by quotas — the worst form of protection.

Our Alternative Proposal

In our judgment, a superior adjustment program would make compensation, training, and relocation benefits available automatically to workers displaced from industries that the ITC determines to be suffering serious injury from imports. The program could also be used to aid workers displaced from industries currently protected by quotas, such as textiles and steel, provided that the quotas are replaced with self-liquidating tariffs.

The compensation component of our proposal would provide qualified displaced workers with two types of earnings-related payments: unemployment compensation and earnings insurance. Existing unemployment compensation programs, which currently compensate eligible unemployed workers for up to 26 weeks in virtually all states, would be left undisturbed. In addition, trade-displaced workers residing in regions of high unemployment, where alternative jobs may be less plentiful, would be eligible for an additional 26 weeks of unemployment compensation payments. Any qualified worker who chose to move in order to obtain new employment would be eligible for a relocation allowance.

Earnings insurance payments, in contrast, would be made to trade-displaced workers only *upon their accepting new employment*; payments would equal a fixed percentage of any erosion in earnings for a particular period of time. Thus, if the compensation ratio were 50 percent, a displaced worker from a designated industry who had earned \$20,000 a year in wages (as reflected on the worker's previous tax returns) and had accepted a new job with a salary of \$10,000 would receive, for a specified period, supplementary payments calculated from a base of \$5,000 per year. The proportion of income replaced could decline over time

"By providing extra compensation to workers after they find new employment, the proposal would give them an incentive to adjust. Rather than remain idle in the hope of reemployment with their old firms, workers could accept jobs paying lower wages . . ."

and could reflect the age and experience of workers. (For example, more junior workers who have built up less human capital in their specific job skills might receive lower replacement rates.) Also, the total compensation payments made to any worker over a given period could be subject to a legislated ceiling.

This proposed earnings insurance mechanism, in conjunction with unemployment insurance, would represent a significant improvement upon current and proposed trade adjustment assistance programs. By providing extra compensation to workers after they find new employment, the proposal would give them an incentive to adjust. Rather than remain idle in the hope of reemployment with their old firms, workers could accept jobs paying lower wages (but offering new career opportunities, training programs, and chances to build up seniority).

A second component of our proposed program would aid workers who prefer to enroll in state-certified training programs. Training expenses would be financed by a combination of grants and loans. Repayment of loans would be made directly through workers' tax returns and would begin only after workers have surpassed their previous peak wage earnings, as reflected on earlier tax returns. The proportion of the retraining cost repaid would vary with the incremental earnings of workers. Workers who exceeded their previous earnings by a large percentage would be expected to repay a larger percentage of their training costs. Such contingent repayment loans — already in effect at some colleges — would allow the government to take equity positions in its citizens. Indeed, contingent repayment should be made a feature of other educational and training loan programs.

Advantages of Our Industry and Worker Assistance Proposals: The Auto Industry as Case Study

The advantages of providing trade protection only in the form of tariffs and using the resulting revenues for trade adjustment assistance in the manner just outlined can be illustrated by examining what would have occurred if, from 1980 to 1984, such a program had been in effect instead of the Voluntary Restraint Agreement (VRA) regarding the export to the United States of Japanese automobiles.

According to the Department of Labor, between 1979 and January, 1984, 225,000 workers were displaced from the U.S. automobile industry. By January, 1984, two-thirds of these workers were reemployed, at median annual earnings some \$4,000 per worker less than before. A tariff providing protection equivalent to that of the VRA would have easily funded a program to compensate for these earnings losses. According to Robert Crandall, whose analysis appeared in the *Review* earlier this year, the VRA increased the average price of Japanese cars by \$1,000 in 1983. The tariff equivalent of this \$1,000 per car increase would have yielded \$1.85 billion in revenues. Such a sum not only would have funded full compensation for the annual income erosion of all reemployed auto workers (total cost \$603 million), but also would have generated \$16,000 for each remaining unemployed worker.

These calculations suggest that even a smaller auto tariff — one that would have provided some relief for American

consumers — would have been more than sufficient to fund our recommended assistance program. According to Crandall, the VRA raised U.S. automobile employment by 46,200. Assuming that a tariff set at half the equivalent level of the VRA would have yielded only a corresponding half increase in reemployment, 23,100 workers would have been displaced. However, with such a lower tariff, U.S. consumers would have saved at least \$500 dollars per Japanese car purchased (and approximately \$200 dollars for each American car purchased). The revenue raised (\$925 million) would have sufficed to offset two-thirds of the income lost by displaced workers reemployed at lower wages (a total cost of \$445 million) — and still yield \$5,860 per unemployed worker for extended unemployment compensation, retraining, and other dislocation assistance.

The experience of the automobile industry over the past four years illustrates well the advantages of our proposal over trade quotas — particularly because that experience poses a severe test. For one thing, a large number of workers who were indirectly aided by the VRA would not have qualified for our program because they were not actually displaced by imports. For another, given their above-average wages, autoworkers as a group experience relatively large earnings losses. In more typical cases, in which more of the employment displacement would be due to imports and workers would suffer less erosion of earnings than autoworkers did, the benefits of our plan could be even greater and the costs even lower.

Assisting Communities

A third major source of political pressure for protection is concern about the impacts of major plant closures on particular communities. Given the large fixed overhead costs of public facilities — schools, utilities, police and fire services — communities in which such closures occur are often forced to add the insult of additional taxes to the injury of an already shrinking populace. Although the concern about these effects has influenced the design of the trade adjustment assistance program, aid to impacted communities has been a virtually nonexistent part of the effort. In its absence, the only mechanism for helping these communities has been legislation adopted in a number of states requiring companies to provide notice in advance of plant closings.

We suggest that a new, positive approach be tried for assisting communities adversely affected by structural changes in the economy. Our proposal would not rely on general appropriations, because that route has proven to be a poor way to target regional assistance. In contrast to the relative success of the ITC procedures, which tie assistance to showings of trade-induced dislocations and confine aid to qualified industries, programs for aiding distressed regions — such as the Model Cities initiative and the work of the Economic Development Administration — have tended to expand beyond their original purposes.

Under our approach, communities would *voluntarily* choose to insure their tax bases against sudden erosion, rather than to depend on a government grant program. The tax base insurance program might, for example, allow a city experiencing an annual loss of more than 5 percent of its tax revenues for reasons other than rate reductions to recover from a government-administered insurance pool some pro-

“Under our approach, communities would voluntarily choose to insure their tax bases against sudden erosion, rather than to depend on a government grant program.”

portion of that loss. The percentage threshold for tax base loss would vary by community size; a lower percentage loss would be required for larger cities. The pool would be financed through insurance premiums paid by communities that elect to join the program. Because the insurance coverage would extend to all sudden diminutions in a community's tax base, all types of communities, not just those experiencing steady long-term population erosions, would be encouraged to participate.

It is possible, of course, to confine such a program to trade-related tax base losses. A mechanism similar to the Section 201 procedure now in effect for industries harmed by trade could be established to determine the causal role of trade in regional economic injury. However, given the voluntary and potentially self-financing nature of our tax base insurance plan, there is no reason in principle or practice why the program should be so restricted.

Conclusion

It is ironic that, despite its commitment to free trade ideals, the Reagan administration has resorted to more extensive quota protection than its recent predecessors. The irony is compounded by the administration's own macroeconomic policies, which stimulate pleas for protection, and by administration cutbacks of adjustment assistance programs that, if effectively designed, could allow a non-protectionist response. Given the current, dangerously protectionist environment, the programs outlined in this article could be an effective microeconomic adjustment strategy complementing the fiscal policy corrections that are required to place the U.S. economy on a path of sustainable growth without permanent protection.

Innovation and U.S. Competitiveness

*Martin Neil Baily
and
Alok K. Chakrabarti*

TH E R E I S no question that the immediate crisis of U.S. trade is primarily a result of the overvalued dollar. And there is no question that reducing the budget deficit is an essential prerequisite for solving this crisis. But the severity of the current problem should not blind us to the longer-term issue of the competitiveness of U.S. industry.

The United States has traditionally been able to pay higher wages than other countries and yet still compete internationally because of superior technology. Productivity was higher than in other countries, and often the items produced were more advanced and could command premium prices. Because of its technological sophistication, the United States was able to develop a unique position in the world economy, and U.S. industries and workers were the beneficiaries.

The unique status of the United States has been eroding, as other countries have been catching up in productivity and product technology. From 1973 to 1984, output per hour in manufacturing grew at only 2.0 percent a year in the United States, compared to 6.7 percent in Japan, 4.5 percent in France, and 3.5 percent in Germany. R&D spending in these countries has also risen faster than our own, and important innovations are being made first overseas. The fraction of U.S. patents granted to foreigners rose from 16 percent in 1960 to 41 percent in 1982.¹

When productivity is rising faster in other major industrial countries than it is in the United States, then U.S. wages and salaries have to decline relative to those elsewhere, after adjusting for inflation, in order for the United States to remain competitive. And when important U.S. industries lack a decisive technological advantage over competitors in low-wage developing countries, then imports come flooding in, causing U.S. job losses and generating political pressures for restrictive tariffs or quotas.

U.S. industry thus has serious problems, but it also has important strengths. Although it is not growing rapidly, the *level* of productivity in the United States is as high or higher than that achieved overseas in most industries. The United States has an unparalleled educational and scientific base, and it puts about as many resources into R&D as Japan, Germany, and France combined.² Moreover, America has developed its high-technology industries rapidly, whereas Europe has not. Seventy percent of all European computer equipment is U.S.-built or supplied by American companies.³ The much-feared Japanese effort to build a super computer, aided by a government grant of \$500 million over 10 years, has to be weighed against the \$3 billion that IBM spent on R&D in 1984 alone.⁴

The overall picture, therefore, is one of both significant problems and substantial strengths. We will explore here some of the facts behind the problems and some public and private policies that might be used to help build on the strengths. The emphasis of our own work has been on innovation. We believe that under-

Martin Neil Baily is a senior fellow in the Economic Studies program at Brookings and the editor of Workers, Jobs, and Inflation. Alok K. Chakrabarti is professor of management at Drexel University. The authors are currently conducting a study of innovation in major industries.

standing the role of innovation is crucial to understanding what has happened and what needs to be done.

The Role of Innovation

The analyses conducted in the 1950s of economic growth were built on the idea that saving and capital investment are the engines of growth. Moreover, economic policymaking in the postwar era has been predicated on the assumption that productivity is enhanced primarily by new plants and equipment. Evidence has accumulated, however, that new technology may be an even more important source of growth. New products and new methods of production are the origin of or the catalyst for productivity advance. For example, Brookings economist Edward Denison finds that only 20 percent of the increase in output per employee over the period 1929–82 was the result purely of increased capital per worker.⁵ Innovation contributes to growth as new ideas are applied directly to improve productive efficiency and as new technology is incorporated into new equipment and new plants. Indeed, without the flow of new technology, capital spending itself tends to dry up. The expansion of capital, as an end in itself, is only a minor motive for investment; the main motive is that new equipment and new technology are purchased together.

Innovation is just as important to U.S. foreign trade. The National Science Foundation has charted with startling clarity (see Figure 1) the extent to which the United States became a net exporter of high-technology products and a net importer of other products in the 1970s. This theme has been reinforced by Brookings author Robert Lawrence, who has also found that high-tech industries have weathered the effects of the overvaluation of the dollar in the 1980s better than other industries.⁶

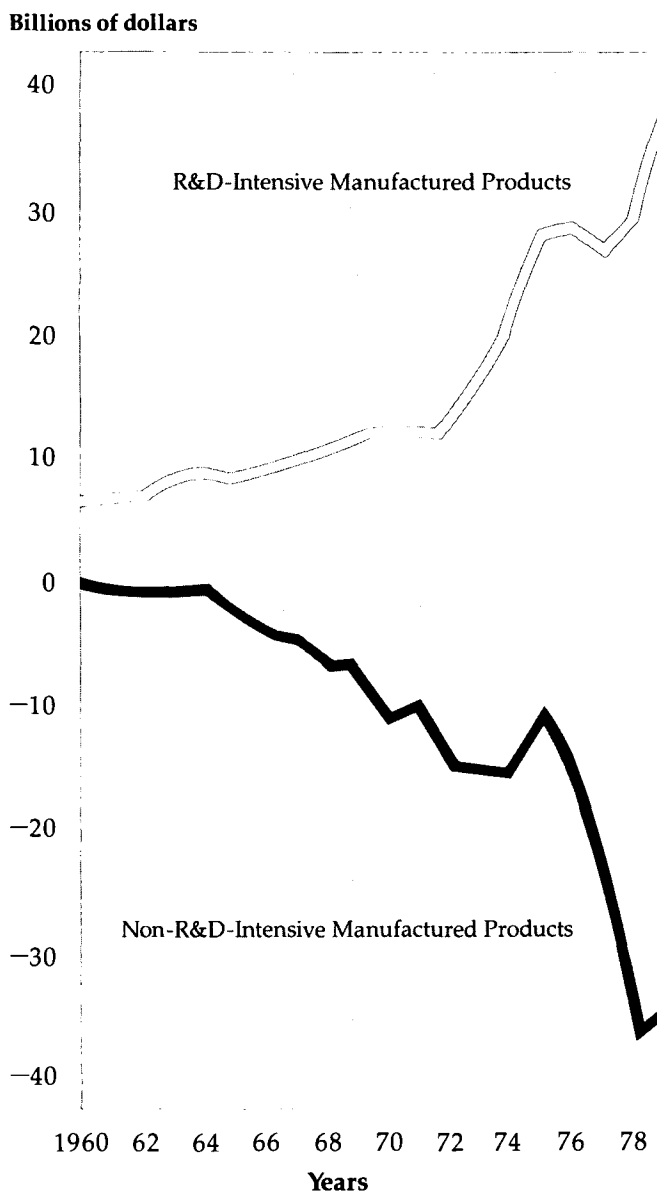
The Slowing of Innovation

There are two important hints that the pace of innovation in the United States has slowed down. The first of these has also been charted by the National Science Foundation (see Figure 2): Patents granted to U.S. inventors peaked in 1972 and declined substantially over the next ten years.

The second reason to think that innovation has slowed is that productivity growth in the majority of U.S. manufacturing industries declined after 1973. Since innovation is a key source of productivity growth, a slowing of the pace of innovation is a likely cause of slow productivity growth. In our own work, we have been looking at precisely this link between innovation and productivity. We analyzed two manufacturing industries: the chemical industry, which had a substantial productivity slowdown in the 1970s, and the textile industry, which did not. We collected information on the flow of innovation in each industry and found a marked relation between innovation and productivity trends: The industry in which productivity slowed—chemicals—was also the industry in which innovation slowed. Figure 3 illustrates this (see page 17).

Since the majority of industries in U.S. manufacturing (and many others, too) had productivity experiences more like that in chemicals than that in textiles, these findings support the view that innovation slowed in the 1970s and pulled productivity growth down with it.

Figure 1.
U.S. Trade Balance in R&D-Intensive and Non-R&D-Intensive Manufactured Product Groups

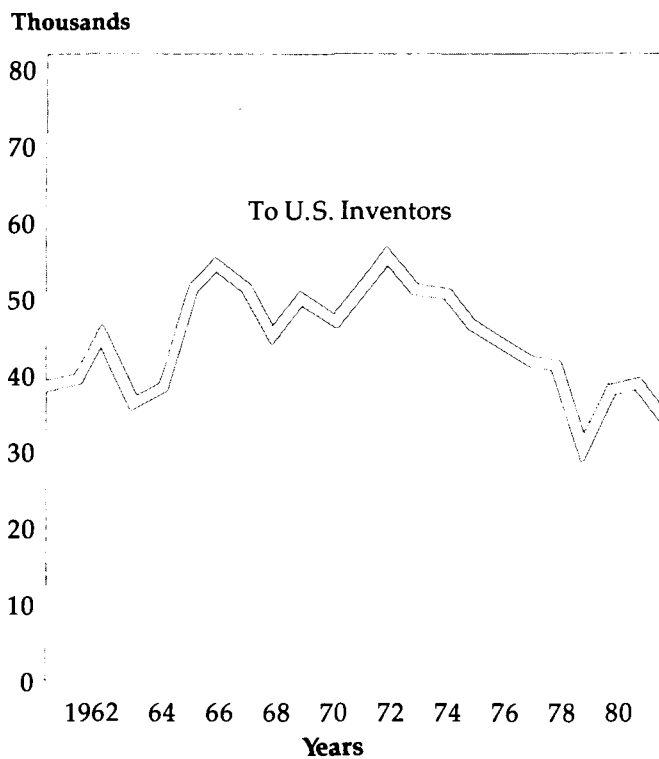


Source: National Science Board, *Science Indicators 1980*, Government Printing Office, 1981, p. 32 (Figure 1-12).

Reasons for Weak Innovation

The slackening of innovation is due in part to the maturing of technology in many fields.⁷ The Great Depression of the 1930s disrupted the economy, deprived the business community of resources necessary for development, and discouraged risk-taking. World War II created a forced-draft of scientific and technological development, but with applications geared to war production. As a result, the postwar period was marked by tremendous opportunities for the commercial development of technology, and these oppor-

Figure 2.
Patents Granted to U.S. Inventors, 1960–82



Source: National Science Board, *Science Indicators* 1982, Government Printing Office, 1983, p. 101 (Figure 4-8).

"Since the majority of industries in U.S. manufacturing (and many others, too) had productivity experiences more like that in chemicals than that in textiles, these findings support the view that innovation slowed in the 1970s and pulled productivity growth down with it."

tunities fueled innovation and productivity growth for two decades.

However, the natural maturing of technology is not an entirely satisfactory explanation for weak innovation. Indeed, the maturing of one direction for progress could have served as a challenge to firms to chart other directions. But in fact this did not happen often enough. Companies decided that the return to technological development had fallen, and they reduced their commitment to it. Rising inflation, together with tax provisions allowing all interest payments to be deducted from income, made it more attractive to purchase safe assets that could be highly leveraged—and decreased the appeal of risky investment in new technology. One sign of this is that company-financed R&D spending grew no faster than GNP over the period 1967–77.⁸ There seems to be a natural law that R&D spending has to grow faster than output if the pace of innovation is to be kept up.⁹ When this acceleration did not materialize in the early 1970s, the pace of innovation fell.

In fairness to the business community, it should be said that external factors played an important role in this decline. Companies had to deal with inflation, deep recession, sharply increased energy costs, and proliferating environmental and worker-safety regulations. The squeeze on R&D budgets came from a squeeze on profits. And technical and managerial resources were diverted away from their normal tasks to deal with energy or environmental problems. Beginning in 1977–78, R&D spending increased rapidly again as companies realized the importance of new technology to growth and profitability.

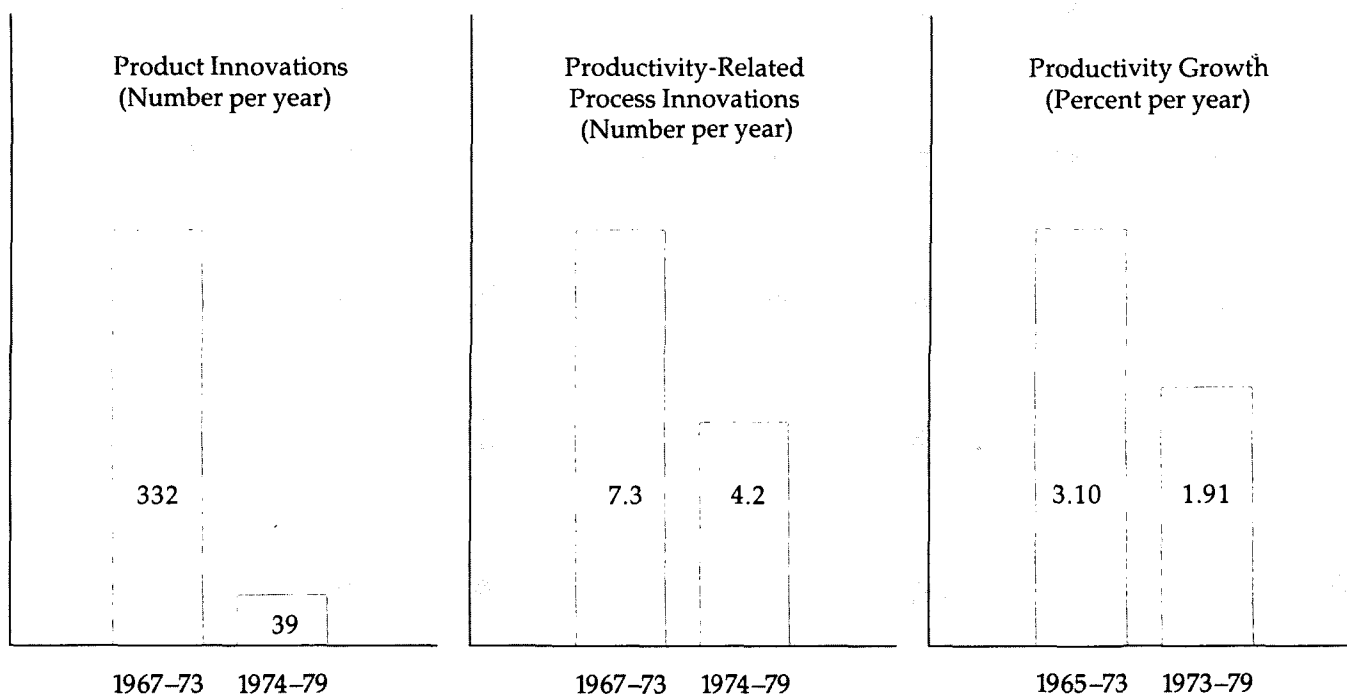
Why Innovation in Electronics Has Not Been Enough

We have said that the United States has been going through a period of weak innovation. That may seem an odd assertion, given the explosion of new computer and electronic innovations in recent years. Indeed, despite fierce competition in consumer electronics and computer chips, the United States remains the overall technology leader in electronics.

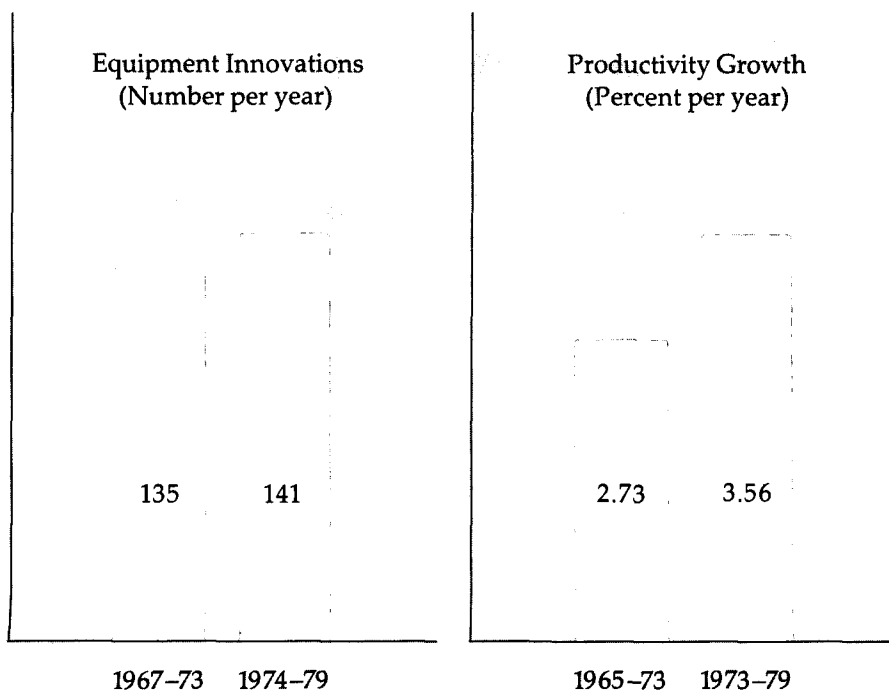
The prospects for U.S. industry would be much bleaker were it not for the success of the electronics industry, and we do not wish to minimize its achievements. But innovation in this industry has not been enough to offset the slowdown elsewhere. The puzzling thing is that the computer revolution has not yet paid off to the same extent as did the earlier generations of innovation. Much of the capital investment made in the United States in the 1970s was for computer and electronic equipment. Such equipment made up 21 percent of all purchases of nonresidential durable equipment in 1973, a figure that had risen to 44 percent by 1983.¹⁰ And yet most of the industries making this investment experienced slow productivity growth. In fact, the fraction of total employment that consists of white-collar workers continued to rise in the 1970s, as did the fraction of clerical workers.¹¹ Within all the major industry groups of the economy, the ratio of overhead or non-production worker employment to total employment also continued to rise in the 1970s.¹² It looks as if the administrative bureaucracies of the economy swallowed a large share of total investment without making corresponding efficiency improvements.

There is one optimistic explanation of the pattern that we

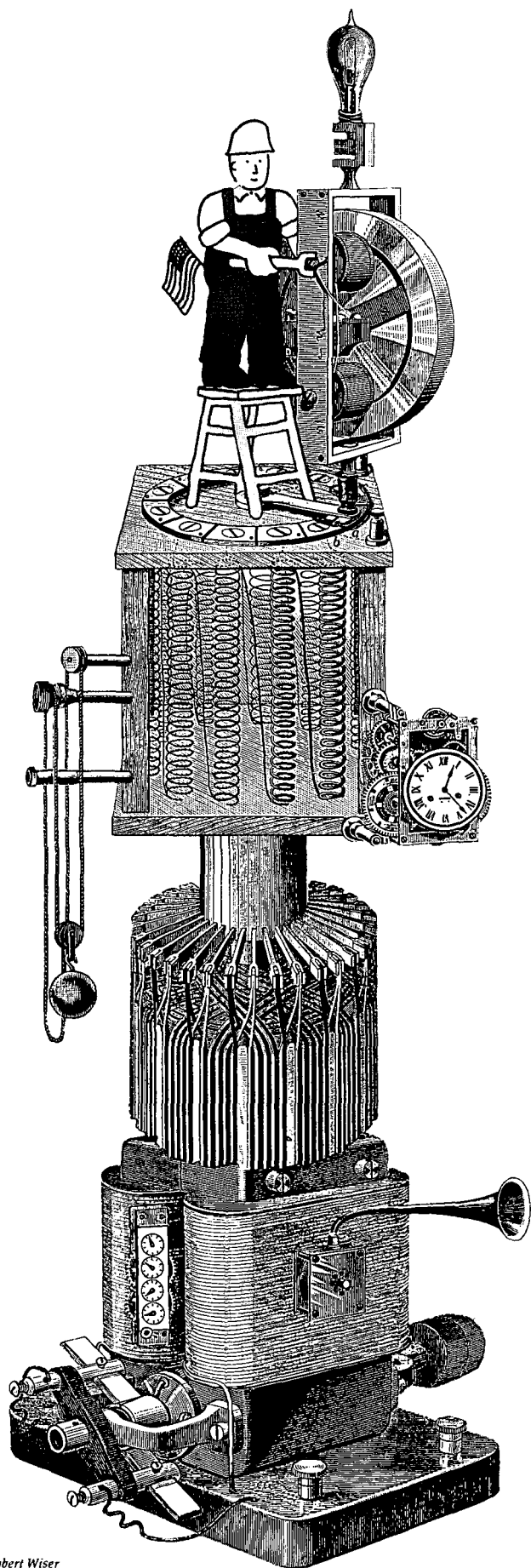
Figure 3.
Innovation and productivity both slowed in the chemical industry...



but not in the textile industry



Source: Martin Neil Bailly and Alok K. Chakrabarti, "Innovation and Productivity in U.S. Industry," *Brookings Papers on Economic Activity*, 2: 1985 (forthcoming).



Robert Wiser

have just described. It could be that the impact of computerization has been to improve the quality of products and services provided and that this improvement is not being picked up. The problem could be in the measurement of productivity, not in productivity itself. And in some areas, this optimistic view must be correct. For example, in financial services a broad range of new products have been offered. The credit card revolution could not have taken place without computerization, and consumers benefit greatly from the resulting convenience.

There is an alternative and more pessimistic explanation, however. Office automation has differed fundamentally from factory automation. When a factory is automated the same output can be produced with less labor, or more output can be produced with the same amount of labor. The company automating has two choices: either to cut employment or to cut prices and expand sales. Either way, productivity rises. When the office is automated there is a third option, which is simply to generate more paper. Each document goes through four drafts instead of two. The accountants simulate the tax consequences of a variety of corporate strategies. The marketing department makes a dozen computer projections based on demographic changes and migration patterns and so on. In addition, the incentives may be wrong. Middle managers are reluctant to share secretaries or reduce the number of people they supervise, so there is persistent overstaffing.

The government has added to the number of ways in which computers are used that may not be fully productive. The tax law has become extremely complex, keeping accounting departments busy and their employment high. And companies must now monitor a whole range of production and employment activities to make sure that they conform to regulatory requirements.

One sign of the importance of this issue is that when electronics has been applied directly to the production of final outputs, it has brought about amazing productivity gains. The telephone communications industry—in which electronic equipment provides service directly to customers—is a good example. This industry achieved a very high rate of productivity growth, and sustained it throughout the 1970s. Another illustration of the same point is the automated teller machine, which has dramatically boosted productivity in the provision of personal banking services.

The more common case, however, is one in which the new technology has been applied to support areas such as accounting, marketing, and personnel.¹³ And it is here that productivity gains may not have been realized, at least not yet.

What Is to Be Done: Business Strategies

Perhaps the most important lesson that comes out of our work on innovation is the importance of viewing technology on a worldwide basis. The United States is no longer alone on the frontier of technology, and the implications of this change have not been fully absorbed. A senior R&D officer at a leading U.S. corporation told us that his company kept a technical listening post in Japan. He was embarrassed about it and tried to take back the information. That is absurd. Of course, his company should be following innovations in Japan. The Japanese have been copying his company's technology for years. His company takes justi-

"Perhaps the most important lesson that comes out of our work on innovation is the importance of viewing technology on a worldwide basis. The United States is no longer alone on the frontier of technology, and the implications of this change have not been fully absorbed."

fiable pride in being the technological leader in its product lines, but that is no reason to neglect worldwide developments in technology. Japan, Western Europe, and even Eastern Europe are major sources of innovation. The United States has supplied technology to the world for decades, and there is nothing wrong in getting a return flow. As other countries catch up in technology and put more resources into research, it is inevitable that more and more innovations will originate outside the United States. Unless U.S. companies track what is happening overseas, they will be left behind in important areas of technology.

This argument does not mean that U.S. industry should try to copy the Japanese road to success. The Japanese are masters at adapting and improving technology and then producing items at low cost. The U.S. comparative advantage is still in advanced technology. The challenge for America is to keep up with the best from overseas and then take another step forward.

The recent fortunes of the American textile-machinery industry illustrate the perils of ignoring foreign innovations. U.S.-built textile machinery was the best in the world for years, but in the 1960s the Swiss and Japanese developed a new shuttle-less technology that offered tremendous cost and productivity benefits. This advance was quickly adopted by European and Japanese manufacturers other than those who had pioneered the development. But the U.S. industry stuck to the task of perfecting the old technology. Most of the spinning and weaving machinery purchased by the U.S. textile industry is now imported.

Viewing technology on a worldwide basis strengthens the case for innovation itself. Information about technology now flows very quickly around the world. In the past, a U.S. industry with a superior technology could count on main-

taining a worldwide advantage in production cost or product quality for several years. Now an innovative new product can be copied and produced overseas more quickly. Continuous technological improvement has become a necessity for maintaining a competitive position.

The second lesson from our study of innovation and productivity is that, if investment in electronics and information-processing equipment has been rising rapidly while productivity has been weak, then it is time to evaluate closely the return from such investments. When office tasks are automated, the staff requirements for completing these tasks should be reduced. The technology should be used in new ways only if they can be demonstrated to be worthwhile. One possible reason for the small productivity impact of computer technology is that companies are engaged in a long-term learning process. Right now the investment does not pay off, but each company continues to spend in this area because it cannot afford to be left behind. That bodes well for future productivity, provided that U.S. industry does in fact move along the learning curve and finds ways to automate white-collar operations efficiently.

What Is to Be Done: Policy

Since innovation is so important to the U.S. economy, an obvious priority of policy should be to make sure that there are adequate incentives for the development of new technology in the private sector. University of Pennsylvania economist Edwin Mansfield has found that the return to society from industrial innovation is much higher than the return to the innovating company. Competitors quickly copy new products, and key personnel change companies or set up their own companies, taking their knowledge with them. The rapid flow of technological information overseas means that repetitions of new products often come from overseas and further erode the returns to U.S. innovators. This diffusion of knowledge benefits consumers because the competition that it creates helps to bring prices down. But the consequently short half-life of a technological edge in the modern world leads to underinvestment in R&D. The private market fails to provide an adequate incentive for innovation.

In these circumstances, it is appropriate for tax policy to give to the private sector an additional stimulus over and above the market incentive. Current tax law does this, as the provisions that allow R&D costs to be expensed and establish an incremental tax credit for R&D spending result in a small positive incentive for R&D. Some economists have expressed concern about the effectiveness of this incentive and about the possibility that companies abuse the tax credit by classifying marketing expenditures as R&D. Indeed, based on these concerns, proposals have been made to reduce or eliminate the current incentive provisions. We believe that *provided* the tax incentives can be properly targeted, they should be retained or even strengthened. Efforts to reduce the budget deficit, which we strongly support, should not eliminate the modest pro-growth provisions now in the tax code.

A second area for policy initiatives concerns steps that the government might take to increase the technological opportunities available to industry. Recent history demonstrates that the government has played a vital role in nurturing high technology in the United States.¹⁴ Programs in the

Defense Department were instrumental in pushing forward the development of early computers, and the aircraft industry continues to be aided by defense money for development. Government's role is so important because there is often a barrier, which private companies cannot overcome, to opening up major new areas of opportunity. Massive resources may be necessary, the risks are extremely high, and once progress has been made, the group that pioneered a development may well not be able to appropriate its benefits.

There is some recognition in Washington of the need to provide an impetus for technological development. The National Science Foundation has shifted its orientation and is increasingly concerned with how scientific development can help the economy. It is setting up centers for "generic" technology development. These try to promote new ways of approaching engineering and scientific problems (e.g., how to minimize friction).

In addition, the link between defense and the development of new technology is cited as part of the case for the Strategic Defense Initiative. The proponents of that program argue that it will help U.S. industry take a giant step forward in computer technology.

Much more needs to be done, however. And the first step should be an evaluation of how the government's role should be structured. The history of government efforts to push forward technology is one of great successes and staggering failures. The atom bomb and the computer were developed; a man was sent to the moon. But the breeder reactor absorbed billions before expiring, and the synfuels project has done no better. The space shuttle is not a disaster, but it has been much more expensive and less reliable than had been hoped.¹⁵

It is in the nature of the task that spectacular successes and failures will occur. After all, government has a role precisely because of the high risks entailed and the large-scale investments required. But, clearly, an institutional framework that can minimize disastrous losses has not been established. Powerful groups and individuals develop vested interests in continuing projects that are going nowhere. The breeder reactor program lasted more because of its ability to generate jobs in Tennessee than because of its technological potential.

Economists have long been preoccupied with policies that control the business cycle or improve static efficiency, but only a few focus on policies for growth.¹⁶ The institutional structure of the Federal Reserve Board has been the subject of exhaustive discourse. But the mechanisms for stimulating technological development have remained on the periphery of economic debate. That must be changed.

A third lesson for policy was underscored earlier: It is vital to view technology in worldwide terms. The textile industry again illustrates the points to be made. First, it is important to understand the linkages between this industry and related industries. The basic raw materials for the production of textiles are wool, cotton, and synthetic fibers. U.S. agriculture is immensely productive and sells cotton around the world. The U.S. chemical industry, which produces synthetic fibers, is a technological leader and sells overseas, but its sales are limited by restrictions on fiber imports in many countries. The production of fabrics by spinning and weaving in the United States teeters on the edge of competitiveness. In 1981, the U.S. industry had a

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small trade surplus, but, as we noted above, it has achieved this position through rapid productivity growth that is largely attributable to innovative foreign-built machinery. Without machinery imports, the U.S. textile industry would not be competitive. Finally, the U.S. apparel industry buys fabric and produces clothing and is not competitive. This industry is labor-intensive, and relatively high U.S. wages push its unit costs above those in developing countries.

How, then, should trade policy be set? Most economists are free-trade purists, and the argument that they make is very strong. The lesson of history and the experience of other countries is that protectionism perpetuates inefficiency and penalizes consumers. Moreover, it is inconsistent for the textile industry to push for protection when the industry is itself dependent on imported machinery.

But free traders are often casual about the costs of their orthodoxy. The textile industry today is bearing the costs of an unsound federal fiscal policy that has led to an overvalued dollar. Moreover, while it can be argued that efficiency would be served by a shrinking of the U.S. apparel industry, such a reduction would also hurt the highly productive U.S. textile fabric and synthetic fiber industries.

On balance, a worldwide perspective on technology strengthens the case for maintaining an open economy. If a foreign country innovates, then U.S. purchasers must have access to the new technology. Quotas, in particular, take away market pressure and reward a reluctance to change. If we are to maintain an open economy, however, U.S. companies must be allowed to compete on fair terms. Fiscal policy that disrupts the normal value of the dollar is simply counterproductive. Moreover, the United States must be willing to threaten trade restraints in order to force other countries to permit U.S.-made goods access to their markets. If the U.S. synthetic fiber and textile fabric industries cannot sell to U.S. apparel manufacturers, they must be allowed to sell to foreign manufacturers that ship clothing to the United States.

In addition, if consumers are to benefit from the flow of cheap foreign goods, then as taxpayers they must also be willing to compensate workers and companies for lost jobs and lost investments. (See the article by Robert Lawrence and Robert Litan in this *Review* for a discussion of these issues.) Temporary tariffs or subsidies may also be appropriate for industries hit by foreign competition at times when the dollar is overvalued. Economic efficiency is not served by wiping out a basically competitive industry because of short-run financial fluctuations.

Conclusions

Innovation is a vital element in the competitive position of the U.S. economy. Traditionally the United States has been the technological leader in most industries and has maintained this status through scientific achievement, government-sponsored technological development, and heavy R&D spending.

Other countries have been catching up to the United States and have overtaken us in some areas. That is not all bad. We can learn from the work of others and accept the fact that not all innovations are made here. But this new order has created difficulties for the U.S. economy, as U.S. industries no longer have a monopoly on the latest technology. Moreover, U.S. innovation appears to have slowed

in recent years and pulled down the rate of productivity growth.

Certainly, there is recognition in Washington of the importance of innovation. It has become a catchword in the Reagan White House and among the Atari Democrats. In this essay, we have suggested that (1) technology must be seen on a worldwide basis by both business and government; (2) investments in office automation must be given the same degree of scrutiny as factory automation; (3) tax incentives should be used to sustain industrial R&D in the face of inadequate market incentives; and (4) ways must be found for the government to sponsor major breakthroughs in technology without falling into the breeder-reactor trap.

Notes

1. National Science Board, *Science Indicators 1982*, Government Printing Office, 1983, table 4-11, p. 287.

2. In 1979, the United States had 620,000 scientists and engineers engaged in R&D compared with 477,000 for France, West Germany, and Japan. Expenditures on civilian R&D place the United States a little behind the total of the other three. See *Science Indicators 1982*.

3. H. E. Fitzgibbons, in *High Technology: Public Policy for the 1980s*, issued by the *National Journal*, Jan. 22, 1983, pp. 39-41.

4. The Japanese project is heavily weighted toward basic research, so that our comparison is not a perfect one. However, the Japanese effort itself seems to be failing. According to the *Wall Street Journal*, Sept. 16, 1985, p. 826, "The flow of government money is slowing, participating companies are increasingly reluctant to donate their engineers and important lines of research are being dropped."

5. Edward F. Denison, *Trends in American Economic Growth, 1929-1982*, Brookings, 1985, table 8-3, p. 113.

6. Robert Z. Lawrence, *Can America Compete?*, Brookings, 1984. Recent U.S. trade patterns are described in U.S. Department of Commerce, *United States Trade: Performance in 1984 and Outlook*, Washington, D.C., June, 1985.

7. We do not have a good explanation for why opportunities dried up in some areas but not others. In part, these differences simply reflect the working out of the random process by which technology is developed. One common theme among industries where productivity growth declined is that many of them exploited the gains from large-scale production in the 1950s and '60s. The potential of this approach was exhausted by the 1970s.

8. *Science Indicators 1982*, table 2-2, p. 234.

9. This law has been propounded by F. M. Scherer, now a visiting scholar at Brookings.

10. Robert Z. Lawrence, "The Employment Effect of the New Information Technologies: An Optimistic View," *Brookings Discussion Papers in International Economics*, No. 20, November, 1985.

11. *Employment and Training Report of the President*, Government Printing Office, 1982, table A-19, p. 178.

12. *Ibid.*, table C-2, p. 241.

13. Wassily Leontief and Faye Duchin, *The Impacts of Automation on Employment, 1963-2000*, New York University, April, 1984, pp. 4-12, estimate that only 10 percent of computers are used to control production machinery.

14. See Jerome E. Schnee, "Government Programs and the Growth of High Technology Industries," *Research Policy*, Vol. 7, 1978, pp. 2-24, and Alok K. Chakrabarti and William E. Souder, "Critical Factors in Technological Innovation and Their Policy Implications," *Technovation*, Vol. 2, 1984, pp. 255-275.

15. In a forthcoming Brookings book, Roger Noll and Linda Cohen will examine the political and economic forces behind several government technology programs.

16. One economist who does look at these issues is Richard R. Nelson. See, for example, *High Technology Policies: A Five-Nation Comparison*, American Enterprise Institute, 1984.

Disentangling the Mess in U.S.-Japan Economic Relations

Edward J. Lincoln

ECONOMIC RELATIONS between Japan and the United States reached a new low in 1985. In March, the Senate passed, with no dissenting votes, a resolution that attacked Japan's trade barriers in telecommunications equipment and called on the president to retaliate. By summer, some 40 pieces of legislation aimed specifically at Japan had been introduced, including several proposals to levy import surcharges or impose other forms of import restriction for which Japan was the sole or principal target. When Congress returned to Washington in the fall, frustration was still running very high and a real possibility existed that it would pass some form of protectionist legislation aimed mainly at Japan as retribution for perceived unfair trade practices. Congress has reacted with anger to Japan in the past as well, but this time that sentiment was stronger and more widespread. Nor has this eruption of ill will been confined to politicians; respected academics and a broad range of private sector spokesmen have been increasingly critical of Japan. How did we reach this sorry state of affairs with a close ally? Are we taking the right approach in dealing with the problems? Could the problems get out of hand — and if they do, what would happen?

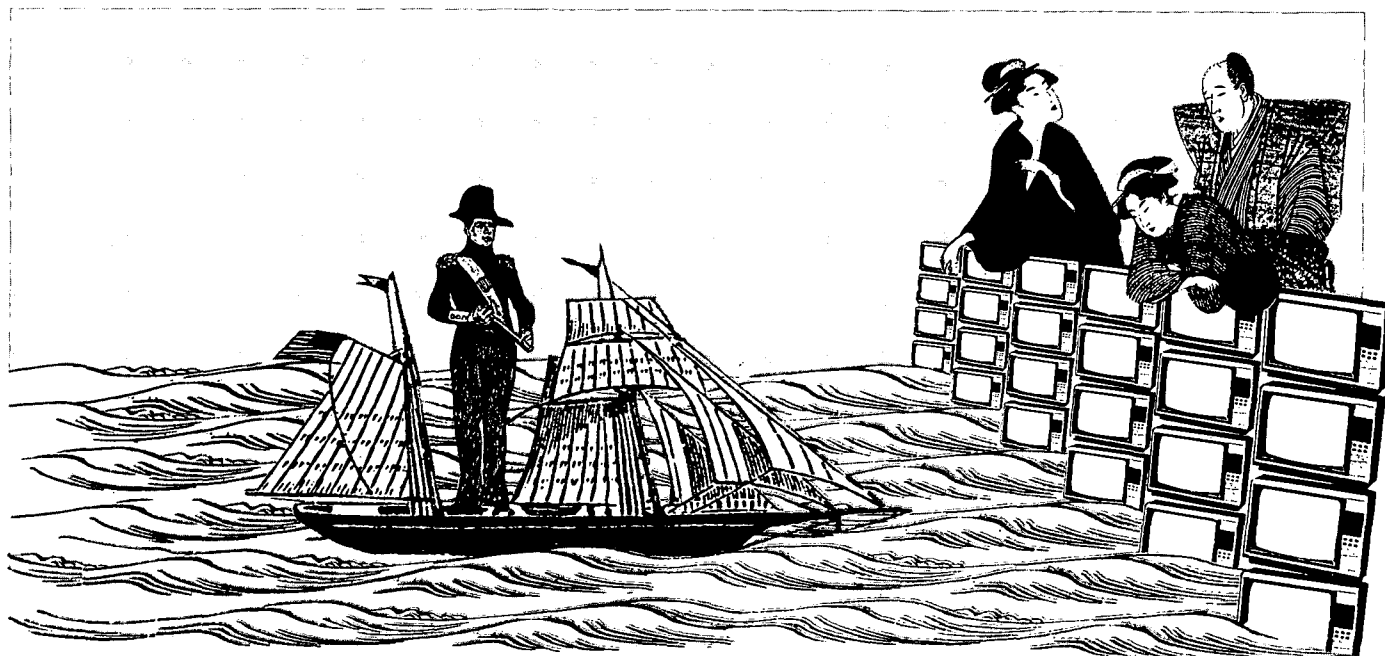
What Is the Issue?

The initiative in relations between the United States and Japan typically lies in Washington, with the Japanese government responding to U.S. demands and complaints. At present, two somewhat separable problems have been defined by the United States. The first is American dissatisfaction with the continued existence of a variety of import barriers in Japan. The Reagan administration, like the Carter regime before it, has made the dismantling of those barriers the primary goal of its economic dealings with Japan. The second problem is the large imbalance of trade between the two countries, and the disparity between Japan's large surplus in world trade and America's deficit.

People often assume that the complaints about barriers are only an outgrowth or manifestation of the trade imbalance. In fact, while the two problems do have some relationship, the connection runs in the opposite direction; the principal problem is the anger over Japan's trade barriers, and the trade figures are convenient bits of data to use in expressing it. The general economic conditions that have led to the U.S. trade deficit obviously increase the difficulties for American companies trying to export to Japan or to compete against imports from Japan in the U.S. market. Those companies are therefore more likely to be watching for unfair Japanese trade actions that could justify petitions to the U.S. government for protection.

But the friction between the United States and Japan involves much more than

Edward J. Lincoln is a research associate in the Foreign Policy Studies program at Brookings and the author of Japan's Industrial Policies. He was formerly the executive vice president of the Japan Economic Institute.



cynical attempts by corporate lawyers to beat Japanese competition in the courtroom; it also reflects the sincere belief on the part of many American leaders that, because Japan is now a large, successful industrial nation with a current-account surplus, it ought to be the most active supporter of the postwar liberal trade regime. Instead, Japan is perceived in this country as being one of the more reluctant participants in the world trade system, eager to export but unwilling to open its markets.

Even though there is an interplay between bilateral trade conflicts and the movements in overall trade balances, the largely differing causes of these two categories of problems mean that separate policies are required to deal with them. Reagan administration policy has focused on the lowering of Japan's import barriers, but that course offers little promise of improvement in trade balances. On the other hand, if the United States (and Japan) emphasize macroeconomic policy changes designed to push current-account balances back toward zero, the issue of restricted entry to the Japanese market would remain. What we need is both an understanding that these two clusters of concerns are distinct and the adoption of separate sets of policies to deal with them.

Macroeconomic Conditions in Japan

For American policy-makers, the least known element in the bilateral equation is the Japanese economy. Any understanding of why Japan has large global trade and current-account surpluses must be informed by a grasp of macroeconomic conditions in Japan. All indications are that economic forces there will continue to generate large surpluses for years to come, barring any unusual external disturbances like the oil shocks of the 1970s.

To appreciate what has happened to Japan, it helps to look back at the era of high economic growth that lasted until 1973. Japan's GNP grew at an average real rate of 10 percent per year from about 1950 to 1973, an unprecedented performance and one marked by a complete absence of true recessions. To make such a high rate of growth

possible, investment had to be an unusually large part of total economic activity. Private-sector investment during the 1960s, for example, averaged 31 percent of GNP, approximately twice the corresponding figure in the United States. Driving this extraordinary level of investment was the expectation of high profits made possible by the importation and use of foreign technology. Several factors were crucial to the success of this "catch-up" process: a social and educational system that produced people able to understand and successfully adapt foreign knowledge to Japanese needs and conditions; a government that was highly supportive of economic growth; and a labor force that was willing to sacrifice or postpone leisure time and social amenities in exchange for rapid income growth.

Unlike many of the countries that are now industrializing, Japan did not rely on borrowing from abroad to finance its very high level of investment. Domestic savings, including net savings by the government, were high and rising, so that the average net inflow of capital from abroad—that is, the average current-account deficit—was close to zero. This outcome was not entirely a product of economic forces, since the government imposed strict controls on all foreign exchange transactions in order to protect the value of the yen under the Bretton Woods system.

Japan's surge of rapid economic growth came to a rather abrupt end in 1973 for a variety of reasons. Most important, the process of technological "catch-up" had been largely completed, reducing the prospects for further jumps in productivity and output from the cooptation of foreign technology. Among the other factors involved were a shift in social priorities, away from a narrow focus on economic growth to a broader concern with the quality of life (including pollution control, and the development of new parks, sewer systems, and paved roads); an increase in labor costs, which led to disinvestment in labor-intensive industries; and a rise in oil costs, which also required structural adjustments. As a result of these changes, the average annual real growth in GNP for the period from 1974 to 1984 was only 3.6 percent, just one third of what the level had been in the high-growth era. Not only was growth lower in absolute

terms, but it was less outstanding relative to the growth rates of other countries. For example, the Japanese rate was almost three times higher than the U.S. rate during the 1960s, but slightly less than twice as high during the past decade.

Lower growth also brought fundamental macroeconomic changes that have had important consequences for Japan's international economic relations. The reduced rate of growth pushed Japan into a position of surplus savings; the society as a whole has been saving more than it wants to invest, with the untapped savings flowing overseas. This situation could also be described as producing more than the society wants to consume, with the remaining output being sold overseas.

This fundamental change in Japan's economic structure was the result of an important shift in the private sector. Lower growth was accompanied by lower levels of private-sector investment, in response to the reductions in expected (and realized) profits inherent in the factors that produced lower growth. Corporate fixed investment as a percentage of GNP dropped by about 10 percentage points, and while household investment rose modestly, its increase did not

offset the large downturn in the corporate sector. Since private-sector savings did not decrease to match the decline in investment, there was a sizable surplus of savings over investment. From 1974 through 1983, this surplus averaged 3.7 percent of GNP; it peaked at 6.5 percent in 1978.

The accounting framework for measuring national income results in a basic identity that essentially means all output must be accounted for. If one sector produces more than it consumes, other sectors must consume more than they produce. Since the data for Japan show surplus savings in the private sector, then either the government sector (through fiscal deficits) or the external sector (through current-account surpluses), or a combination of both, must have absorbed them. Over the past decade, both have done so. Had neither the government nor the rest of the world been willing to absorb those surplus savings, another force — namely, a prolonged economic slump — would have pushed private-sector savings and investment closer together.

Enlargement of the government deficit in the 1970s absorbed most of the surplus. To some extent this development was unintended; as government spending increased along lines established in the early 1970s, the recession and subsequent slower growth held tax revenues far below expectations. The United States contributed to the imbalance by pressuring Japan in 1977 and 1978 to use greater fiscal stimulus as part of a "locomotive" strategy for pulling the world out of a prolonged stagnation following the oil shock. Japan's deficit reached a peak of 5.5 percent of GNP in 1978, and in the following year an unprecedented 36 percent of government spending was deficit-financed.

Alarmed by the size of these deficits and bolstered by private-sector demands for greater efficiency in government, the Ministry of Finance embarked on a campaign to bring the deficit down through a combination of tax increases and strict controls on spending. Large increases in overall tax rates proved politically impossible, leading prime ministers Suzuki and Nakasone to promise to reduce deficits without raising taxes. Their pledges left the Ministry of Finance with a limited range of options for boosting revenues: reductions in the scope of preferential tax treatment, increases in various excise taxes, and a myriad of other rule changes.

Accordingly, Japan's program to reduce deficits has focused on expenditure controls. For fiscal years 1980 through 1985, the average annual increase in central government spending has been only 3.7 percent, compared to an average of 18 percent during the 1970s; only part of this decline is due to the reduction in inflation. The burden of holding down spending has been distributed across most budget categories, although both defense spending and foreign aid have been granted exceptions to the annual guidelines, and some areas have been cut more than others (for example, the budget for public works projects, which dropped by almost 13 percent from fiscal 1982 to fiscal 1985).

The determination to adhere to austerity remains strong, despite some rhetoric to the contrary in Japan. Prime Minister Nakasone was head of the Administrative Management Agency when the administrative reform movement got underway in 1980, and he has remained firmly committed to the concept ever since. Both Toshio Komoto and Kiichi Miyazawa had planned to challenge Nakasone for the pres-

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idency of the Liberal Democratic Party in 1984 by advocating a less ascetic fiscal policy, but their candidacies fizzled — leaving Nakasone as president and, therefore, prime minister until December, 1986. He appears to be unlikely during the remainder of his term to move very far from his firm commitment to austerity.

Concern about trade relations with the United States and about the possibility of a slowdown in Japan's economic growth if the United States were to slide into recession have led the Liberal Democratic Party to endorse the deregulation of industry to stimulate investment and a vaguer concept of "encouraging private sector vitality." These proposals generated a great deal of discussion in 1985, but without new spending the government's ability to stimulate the private sector will be quite limited. Thus, at the same time that discussions are proceeding on the easing of housing regulations (for example, the relaxation of height limits on dwellings), government financial support of housing investment has been cut in the budget proposal for fiscal 1986. Therefore, even though the rhetoric regarding economic stimulation will continue into 1986, little real or effective government action appears likely.

What has happened to the current account as the other element offsetting surplus private-sector savings? Because of the rapid increase in government deficits during the 1970s and the temporary effects of the two oil shocks, the average current-account surplus was actually quite low for the period from 1974 to 1983: only 0.6 percent of GNP. The two oil shocks actually produced current-account deficits for several years, but Japan quickly returned to surpluses once its economy had adjusted. In 1984, the \$35 billion current-account surplus came to almost 3 percent of GNP, and all indications are that the level for 1985 will be even higher.

Economic forecasters are predicting a continuation of current-account surpluses in the future, probably on the order of 1.5 to 2.0 percent of GNP. These projections assume that real GNP growth will continue to average about 4 percent and that investment will remain at levels much lower than those of the 1960s, leading to a persistence of surplus savings in the private sector. Government is expected to persevere in its efforts to lower deficits, so that it will fail to absorb a larger share of those surpluses (and may in fact absorb less of them). Thus, the current account will remain in surplus unless international economic factors force a reversal of the economic tendency for surplus savings. In its 1984 white paper on the economy, the Economic Planning Agency adopted this interpretation of the future and argued that current-account surpluses are good for the world (because they mean that capital is flowing out of Japan to other countries) and that they reflect a stage of economic development that both Great Britain and the United States passed through earlier. These positions are now standard fare in bilateral discussions.

While the Japanese government's defense of continued large surpluses has a large element of truth to it, the fact remains that these surpluses create serious international problems for Japan. The current account consists of merchandise trade, services trade, and unilateral transfers. Japan has consistently had large deficits in services trade (a situation that is now rapidly changing as income from investment abroad grows), so that the merchandise trade surpluses have been even higher than the current account figures — \$44 billion in 1984, for example. In addition, the fact

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that Japan is an importer of raw materials and an exporter of manufactured goods means that its surpluses are concentrated in trade with other advanced manufacturing nations, like the United States. Even when Japan's trade balance has been zero or negative (as it was immediately after the two oil shocks), it has still had surpluses with other industrial nations to offset deficits with countries that supply it with raw materials. Large global current-account surpluses, therefore, involve large bilateral surpluses with the United States — an imbalance that generates tension between the two countries.

Over the past several years, macroeconomic developments in the United States moved in exactly the opposite direction from those in Japan. While the Reagan tax cuts dramatically increased federal deficits, neither private-sector savings nor investment rates changed much from their historical averages. Fiscal policy thus pushed the United States into current-account deficits, as the combined private and government demand for funds exceeded the supply of domestic savings. Therefore, in contrast to Japan, which has been a savings-surplus nation despite its budget deficits, the United States has become a savings-deficit nation

because of its budget shortfalls. The impacts of these fiscal imbalances on U.S. interest rates and the exchange value of the dollar have pulled more exports and capital from Japan — a major reason why the 1984 and 1985 current-account surpluses in Japan are so much higher than had been anticipated.

Trade Barriers

The other set of bilateral difficulties has been product-specific in nature. These problems have concerned both Japanese access to the U.S. market and American access to the Japanese one. The two nations have tended to address their differences in noisy, unpleasant, publicized struggles, often marked by complaints in the United States that Japan is “unfair.”

Behind this label lies a basic commitment in the United States to the principle of free trade. We may not abide by that principle any better than other nations do, but it is a fundamental part of our ideology. Therefore, American departures from the norm of free trade may be made only in response to unfair actions by a trading partner — a justification that is part of the General Agreement on Tariffs and Trade, the basic document governing international trade in the postwar period. Consider an example: The Japanese automobile industry, which erred only by happening to have small cars to sell in the United States when demand shifted in that direction after the 1979 oil shock, was accused of being unfair because it did not invest in assembly plants in the United States. As this instance suggests, any U.S. company that desires to limit its foreign competitors in the domestic market looks for actions by those competitors that can be construed as unfair under U.S. trade law or in the eyes of politicians and voters. Since Japan has been a very successful exporter to the United States, rapidly moving up the industrial ladder from textiles to automobiles since the 1950s, it has been the object of a considerable portion of U.S. protectionist actions.

This interpretation of the nature of protectionist forces does some injustice to American corporations. Even without corporate lawyers looking for ways to move the locus of competition from the market to the courtroom, one is struck by the widespread, sincere belief that Japanese companies are unfair or sneaky in their attempts to penetrate the U.S. market (or to keep American products out of Japan). A large part of the explanation for this perception appears to be sociological; Japanese and American companies define ethical behavior differently, so that what the Japanese see as normal aggressive competition is often viewed here as abnormal and unacceptable.

When the bilateral trade balance deteriorated so rapidly in 1984, the big change was in a steep rise in the volume of Japan's exports to the United States — a development that one would have expected to generate a surge of complaints and protectionist actions. Surprisingly, Japanese competition in the United States has not been a major focus of bilateral problems recently. Even the bills in Congress that include protectionist threats intend them to be tools rather than ends in themselves. The more important issue has been access to the Japanese market.

Trade barriers in Japan have generated heated discussions. The Japanese insist vociferously that their market is “wide open,” as a recent government publication put it,

while Americans complain bitterly about a closed market. Tariffs are certainly low on average and formal quotas rather few in number. However, the tariff and quota barriers that do exist tend to be on products of great interest to Japan's trading partners. In addition to these visible barriers, though, there is an amorphous array of standards, testing procedures, and disclosure requirements that American firms assume are manipulated to their disadvantage. The problems generated by those additional rules of the game do not lend themselves to measurement, leaving any debate about them mired in an endless series of anecdotes.

Nevertheless, several small pieces of evidence appear to be relevant here. First, it is not only the United States that is unhappy with the degree of access to the Japanese market. Virtually every country exporting manufactured goods to Japan has serious complaints; Americans may fail to understand Japan or work aggressively to penetrate its market, as the Japanese allege, but it is difficult to see why everyone else—including, for instance, Korea—should fit this characterization. Second, many American companies point out that their market shares relative to those of Japanese competition are much larger in third-country markets than in Japan, which at least suggests that their difficulties in Japan are due to barriers rather than an inability to compete. Third, the share of manufactured goods in Japan's import structure remains low despite two decades of dismantling

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tariff and quota barriers. The change in the relative price of oil affects this proportion, but Japan's record stands in contrast to those of most other oil-importing industrial countries.

Much of the current tension between the United States and Japan is due to America's sense that Japan remains a relatively protected market and that the Japanese, by not acknowledging that this is the case, are being less than honest with us. Moreover, there is an expectation that Japan, which is still experiencing faster economic growth than other industrial nations, and which has a large trade surplus, ought to be a leader of the liberal trade regime. Thrust into the limelight after three decades of invisibility in international diplomacy, however, Japan has appeared ill-prepared and unwilling to play this role.

Policy Options

Can anything be done to reduce the tension in bilateral economic relations? Should anything be done? Since we have two sets of problems—one regarding the overall trade imbalance and the other regarding specific products—two sets of policies are needed. My own view is that we ought to be able to reduce the severity of these problems, but that the general level of noise in the relationship between the two countries is likely to remain rather high.

The overall imbalance calls for macroeconomic adjustments. The strategy that materialized at the end of September of this year—coordinated direct intervention in exchange rates to bring about appreciation of the yen and depreciation of the dollar—treats symptoms more than causes. If intervention is to be successful, it must cause the key macroeconomic variables—private savings and investment or the government deficit—to move. A better approach would be for both Japan and the United States to alter their fiscal policies, with Japan stimulating its economy by allowing its government deficit to rise and the United States bringing its deficit under better control. Without intentional changes in fiscal policy, intervention could still work if it forces involuntary and perhaps unpleasant adjustments. For example, if intervention causes investors to shift away from dollar-denominated assets, U.S. interest rates would rise, cutting private-sector investment and pushing the economy toward recession.

The Reagan administration has avoided discussing macroeconomic issues with Japan, perhaps because it has not been very successful in taking the first step by dealing with its own deficits. We cannot seriously expect Japan to respond favorably unless the United States is willing to act first. In any case, if the administration raises the question of fiscal policy in Japan, it will encounter resistance. The Ministry of Finance and Prime Minister Nakasone remain firmly committed to their program of austerity, the reversal of which would not be at all easy for them to accept. In light of the relatively high deficits that the Japanese have incurred in recent years, debt service costs that are over 20 percent of the central government budget, and a stock of outstanding debt that is now approaching 50 percent of GNP, one can have some sympathy for their position. Nevertheless, there is a constituency for stimulus in Japan, as evidenced by the outburst of discussion when, in an April, 1985, speech, Secretary of State George P. Shultz made a very few vague comments about the advisability of

Japan stimulating its economy. If we can accept the criticism of the United States that would be attendant upon our initiation of a dialogue with Japan about macroeconomic policies, this course would offer some hope for positive results. I believe that it ought to be pursued.

If the United States and Japan altered their fiscal policies or took steps to adjust their external balances, some of the antagonism and tension in bilateral relations would disappear. As to issues regarding specific products, it would be incumbent upon Japan to continue making good faith efforts to reduce its barriers to entry. It could, for example, negotiate with the United States accelerated implementation and meaningful monitoring of the market-opening measures announced at the end of July, 1985. Those measures were to be phased in over a three-year timetable, but the wording of the package was in many places vague and left individual ministries a great deal of discretion over actual implementation. When it was announced, the package was not well received in Washington, but serious bilateral talks resulting in measurable progress could do much to reverse that reaction. Such talks have in fact begun. Should Japan fail to demonstrate good faith in reducing barriers, Congress can be expected to lash out quickly.

One impediment to the smoothing of relations is the disparity between the two societies. Americans are easily frustrated by Japanese negotiating styles and feel that they cannot achieve any progress at all without making dire threats. The Japanese believe that problems would disappear if Americans understood Japan better, but what they mean by understanding is the acceptance of Japan's policy positions. If Americans were to learn how to lobby for their interests more effectively in Japan, as the Japanese have learned to do in the United States, perhaps some of the histrionics in our dealings could be eliminated. But we may well have to resign ourselves to the continuation of a rather high volume of noise in bilateral affairs—and just hope that it can be contained sufficiently to prevent a spiral of protectionism. Given the severity of current problems, some increase in protectionism is likely, but that may simply be the price of preventing a worse outcome.

To end on a more optimistic note, it should be recognized that Japan can ill afford a serious rupture in its close economic ties with the United States. Over the past several years, the share of its exports sent to the United States has risen from 25 percent to 35 percent. Should that trade be disrupted, no other market could truly take the place of America; the Japanese economy would suffer. Moreover, economic dealings between the United States and Japan cannot be divorced entirely from our overall bilateral relationship, and Japan has no realistic alternative to its close diplomatic and military ties with the United States. Neither China nor the Soviet Union represents a feasible alliance partner for Japan, and without much higher defense spending Japan certainly cannot choose to be unaligned. The Japanese recognize their dependency and their policymakers are rational people; they have incentives to prevent any serious deterioration in bilateral relations. Good intentions, however, do not always lead to the best policies, and the Japanese government has been singularly inept in some of its efforts to deal with trade problems. Should these problems get out of control, therefore, it is likely to be the result of miscalculations rather than an angry, irrational outburst.

The United States as an International Debtor Country

Edward M. Bernstein

ACCORDING TO a recent report of the Department of Commerce, the United States has become a net debtor country for the first time since 1914. As Table 1 shows, at the end of 1984 the value of U.S. assets abroad (\$915 billion) still exceeded the value of foreign assets in the United States (\$886 billion). However, new investments in this country by foreigners in the first half of 1985 amounted to nearly \$40 billion, while new U.S. investments abroad were only \$5 billion. Therefore, at the end of June, 1985, the value of foreign assets in the United States exceeded the value of U.S. assets abroad by \$6.5 billion.

The emergence of the United States as a net debtor country is causing great concern among policy-makers and the public. There is a fear that the increased payments of income on foreign investments in this country will impair the American standard of living. There is also a fear that if foreigners were to withdraw their investments, the United States would be confronted with a debt crisis much like those of some developing countries. From an international perspective, there is concern that the United States, with its very high per capita income, is absorbing from abroad savings that are needed by other industrial countries to finance their recovery from recession and by low-income countries to finance their development.

This article addresses four aspects of America's new status as a net debtor country. First, it explains how the official estimates of the international investment position are made and why they understate the net debtor position of the United States. Second, it discusses why the United States became a net debtor country. Third, it analyzes the present and prospective earnings of U.S. investments abroad and foreign investments in this country. Finally, it considers the frequently expressed concerns about the U.S. debtor status.

U.S. Net Investment Position

U.S. Assets Abroad

The period since the end of World War II has been marked by an enormous increase in world trade, and in recent years by an even greater increase in investment—by the United States in foreign countries and by foreigners in this country. According to the estimate of the Department of Commerce, as shown in Tables 1 and 2, the value of the foreign assets owned by the U.S. government, American banks and business firms, and other residents of the United States increased from \$448 billion at the end of 1978 to about \$920 billion in mid-1985.

The assets of the U.S. government consist of its monetary reserves and loans and other short-term assets. The reserve assets were valued at \$36 billion at the end of June, 1985. This understates their actual value, because the gold reserves—

Edward M. Bernstein is a guest scholar in the Economic Studies program at Brookings. He served as the executive secretary and chief technical adviser of the U.S. delegation to the Bretton Woods conference and has been a professor of economics at the University of North Carolina, director of research at the International Monetary Fund, and president of EMB, Ltd., Research Economists.

which were valued at \$11 billion, the official monetary price — are worth over \$85 billion at the present market price. On the other hand, the actual value of the loans and other foreign assets of the government is considerably less than the book value of \$86 billion, because the interest rates on the loans are much lower than current market rates.

U.S. private assets abroad amounted to about \$798 billion at the end of June, 1985. More than half of these assets were claims reported by U.S. banks; their book value was \$439 billion, without adjustment for the creditworthiness of debtors or the current status of interest and amortization payments. U.S. private assets also include direct investments abroad, which were valued at \$237 billion — about what the market value of similar enterprises would be in this country on the basis of their current earnings and the price/earnings ratios for shares of domestic companies. Other private assets include commercial and financial claims of unaffiliated nonbanking concerns, valued at nearly \$28 billion; American holdings of foreign bonds, valued at \$64 billion; and holdings of foreign stocks, valued at \$30 billion (based on market prices at the end of 1984, without adjustment for changes in prices and exchange rates in the first half of 1985).

Foreign Assets in the United States

The value of foreign assets in the United States increased from \$372 billion at the end of 1978 to about \$926 billion at the end of June, 1985. Foreign official assets, which are mainly the dollar reserves of foreign governments, amounted to \$196 billion. About five-sixths of these funds are held in U.S. government securities and in claims on U.S. banks. Foreign official assets also include other claims on the U.S. government, which are mainly prepayments on military orders, and some investments in corporate stocks and bonds.

Other foreign-owned assets in the United States were valued at \$730 billion at the end of June, 1985. Of these, about 45 percent — \$326 billion — were liabilities reported by U.S. banks, mainly to foreign banks (including foreign

“According to a recent report of the Department of Commerce, the United States has become a net debtor country for the first time since 1914.”

offices of U.S. banks). The book value of foreign direct investments in affiliated enterprises in this country was \$167 billion in mid-1985. Liabilities of U.S. nonbanking concerns to foreigners, which are mainly for imports and loans from foreign banks, were \$28 billion at the end of March, 1985. Foreign investments in American securities, other than those included in holdings of foreign official agencies, amounted to \$210 billion at the end of June, 1985, nearly half of which was in corporate stocks. These securities were valued at market prices at the end of 1984 and adjusted for net purchases in the first half of 1985.

Statistical Discrepancy

Another reason why Table 2 understates the net debtor position of the United States is that a large amount of foreign assets in this country is not reported as foreign-owned.

Table 1. Net Investment Position of the United States, 1978-85

	Billions of dollars; end of period							
	1978	1979	1980	1981	1982	1983	1984	1985-II ^a
U.S. assets abroad	447.8	510.6	606.9	719.7	839.0	893.6	914.7	919.5
Official reserve assets	18.7	19.0	26.8	30.1	34.0	33.7	34.9	35.5
Other government assets	54.2	58.4	63.5	68.4	74.3	79.2	84.6	86.4
Private assets	375.0	433.2	516.6	621.2	730.7	780.8	785.1	797.5
Foreign assets in U.S.	371.7	416.1	500.8	579.0	692.0	787.6	886.4	925.9
Foreign official assets	173.1	159.9	176.1	180.4	189.2	194.5	199.0	196.0
Other foreign assets	198.7	256.3	324.8	398.6	502.8	593.1	687.4	730.0
Net investment position	76.1	94.5	106.0	140.7	147.0	106.2	28.2	-6.5

^a Values at the end of June, 1985, without adjustment for changes in prices and exchange rates that occurred in the first half of 1985.

Source: *Survey of Current Business*, June, 1985, pp. 23-33, and September, 1985, p. 84.

Table 2.
International Investment
Position of the United States,
1985

	Millions of dollars		
	Dec. 31, 1984 ^a	Capital flows Q-1 and Q-2 1985 ^b	Estimate June 30, 1985 ^c
A. U.S. assets abroad	914,693	4,763	919,456
B. U.S. official reserve assets	34,934	589	35,523
Gold	11,096 ^d	...	11,096
Special Drawing Rights	5,641	444	6,085
Reserve position in the International Monetary Fund	11,541	-353	11,188
Foreign exchange	6,656	498	7,154
C. U.S. government assets, excluding official reserves	84,634	1,767	86,401
Loans repayable in dollars	80,844	1,923	84,584
Other loans	1,817		
Nonconvertible currencies and short-term assets	1,973	-156	1,817
D. U.S. private assets	795,125	2,407	797,532
Direct investment	233,412	3,737	237,149
Foreign bonds	61,973	2,409	64,382
Foreign corporate stocks	27,902	1,947	29,849
Claims of unaffiliated U.S. nonbank concerns	28,829	-1,201 ^e	27,628
Claims reported by U.S. banks, not included elsewhere	433,009	-4,485	438,524
E. Foreign assets in the United States	886,448	39,500	925,948
F. Foreign official assets	199,021	-3,050	195,971
U.S. government securities	142,909	1,131	144,040
Other U.S. government liabilities	14,721	41	14,762
Liabilities reported by U.S. banks, not included elsewhere	26,197	-3,284	22,913
Other foreign official assets	15,194	-938	14,256
G. Other foreign assets in the United States	687,427	42,551	729,978
Direct investment	159,571	6,984	166,555
U.S. Treasury securities	56,870	7,924	64,794
Corporate and other bonds	32,290	17,326	49,616
Corporate stocks	95,911	-699	95,212
Liabilities of unaffiliated U.S. nonbank concerns	30,488	-2,655 ^e	27,833
Liabilities reported by U.S. banks, not included elsewhere	312,297	13,671	325,968
H. Excess of U.S. assets abroad over foreign assets in the United States (net capital position)	28,245	-34,737	-6,492

^a At prices and exchange rates for some assets at the end of 1984.

^b Capital flows at dollar values during the first half of 1985.

^c Values at end of 1984 plus capital flows in first half of 1985.

^d Gold valued at official monetary price of \$42.22 a fine troy ounce.

^e Capital flows in the first quarter of 1985.

Estimates of annual changes in the international investment position are made on the basis of changes in prices and exchange rates for some assets and the net inflow and outflow of capital that is reported in the balance of payments. Some transactions are omitted from the balance of payments and others are reported at an erroneous value. These errors and omissions show up in the balance of payments as a discrepancy between the reported transactions and the changes in the monetary accounts. Thus, the statistical discrepancy is equal to the excess of unreported receipts over unreported payments (net receipts) or the excess of unreported payments over unreported receipts (net payments). As the statistical discrepancy showed net receipts of \$117 billion in 1981–84 and the first half of 1985, it makes a great difference to the U.S. investment position whether these net receipts came from unreported current or unreported capital transactions.

There are reasons for believing that in the past few years the statistical discrepancy has been due mainly to unreported capital transactions. First, changes in the statistical discrepancy have been very large from year to year and even from quarter to quarter. It is unlikely that errors and omissions in transactions in goods and services would change so much so quickly. Second, in the past the statistical discrepancy has shown large net receipts from unreported transactions when the dollar was strong and the capital inflow was increasing, and large net payments for unreported transactions when the dollar was weak and the capital outflow was increasing. This pattern suggests that the errors and omissions in 1980–85 were mainly unreported capital inflow. Some of the unreported capital inflow may be repatriated U.S. funds, and some may be funds of immigrants — that is, assets owned by present U.S. residents. Most of the unreported capital inflow, however, must be foreign funds held in this country in domestic names and addresses.

Why the United States Became a Net Debtor Country

Three years ago, the United States was a very large net creditor country on international capital account. The deterioration in its investment position since then is the result of the huge balance of payments deficit on current account. In 1981 and the first half of 1982, the current account was in surplus by over \$6 billion a year. In 1984 and the first half of 1985, it was in deficit by about \$110 billion a year. Nearly all of the deterioration in the current account was the result of the increase in the trade deficit, although net receipts from services, particularly investment income, also fell considerably.

A deficit on goods and services shows the amount by which consumption and investment exceed domestic output. It also shows the amount by which domestic savings fall short of domestic investment. The budget deficit of the federal government is sometimes said to be the cause of the deficit on goods and services. The budget deficit did have a very stimulative effect on the economy, apart from the international trade sector. However, as the unemployment rate was high in 1981–85 and the factory utilization rate was low in spite of the fiscal stimulus, the huge deficit on goods and services could not be due to excessive domestic demand. The budget deficit did, of course, absorb domestic

savings so that they fell short of domestic investment. But that is not the reason for the deficit in the balance of payments on current account and the corresponding net inflow of capital from abroad. In part at least, the causal relationship was in the other direction. The deficit on current account caused output and income to fall in the sectors dependent on exports or competing with imports. If the deficit on current account had been smaller, the deficiency in domestic savings would have been less. Output and income would have increased more, private savings would have been larger, and the budget deficit would have been smaller.

The huge increase in the current account deficit in recent years is the result of complex forces that affected U.S. trade with different countries and regions in different ways. Between 1981 and 1984, the trade deficit increased from \$28 billion to \$108 billion, and in the first half of 1985 it rose further to an annualized rate of \$124 billion. The increase in the trade deficit was especially large with Western Europe, Latin America, Canada, and Japan. In part, this surge was due to the debt crisis in Latin America and the greater cyclical expansion in the United States than in Western Eu-

“Another reason why Table 2 understates the net debtor position of the United States is that a large amount of foreign assets in this country is not reported as foreign-owned.”

rope and Canada. Mainly, however, the increase in the trade deficit was due to the appreciation of the dollar against the Western European currencies and the chronic undervaluation of the yen, which undermined the competitive position of the United States in the domestic market and in foreign markets.

From mid-1980 to early March, 1985, the dollar rose by an average of 98 percent against the currencies of the ten major industrial countries. Such a large appreciation of the dollar at a time when the balance on current account was falling sharply could have been due only to the enormous inflow of capital. The usual explanation is that this inflow came in response to the higher real interest rates in the United States caused by the budget deficit. While interest rates rose and fell in all industrial countries during this period, the difference between money market rates in the United States and those in Germany, for example, changed very little after 1981. As prices rose more in the United States than in Germany, the difference in real interest rates actually narrowed somewhat between 1981 and 1985.

As a practical matter, traders in foreign exchange are not concerned with real interest rates, but with nominal interest rates adjusted for the expected change in exchange rates. If buyers of dollars were mainly concerned with differences in real interest rates, they would not have bid up the rate for the dollar in deutsche marks by 95 percent in order to earn about 4 percent more per annum for an uncertain period, with the risk that the dollar might fall again, as it did after March, 1985. Besides, if higher U.S. interest rates attracted the very large inflow of foreign funds, they should at the same time have impeded the outflow of U.S. funds. In fact, the increase in the foreign loans of U.S. banks far exceeded the increase in their foreign liabilities in 1980-82 and the first quarter of 1983. This relationship changed only when U.S. banks stopped making new loans to Latin America.

The main reason for the huge capital inflow was the increased preference of foreigners for having dollar assets in the United States, particularly in the form of direct investment. The appreciation of the dollar did not deter such investment. Although the dollar became dearer in foreign currencies, the assets that could be bought with dollars seemed cheap to foreigners. This valuation also encouraged foreign investment in U.S. corporate stocks until the first quarter of 1984. Foreign purchases of U.S. corporate bonds, however, were very small when U.S. interest rates were rising, but increased sharply after mid-1984, when U.S. interest rates fell. Further, a large amount of foreign capital, including unreported funds, came to the United States in 1980-85 in search of a safe haven and in the hope that the dollar would appreciate.

There will always be a net inflow of funds from abroad equal to the deficit on current account, because without such financing it would not be possible to incur the deficit. However, the exchange rate at which there will be a balancing inflow of capital will depend on the foreign preference for holding dollar assets. In any case, the U.S. current account deficit cannot be reduced significantly until the foreign exchange value of the dollar has fallen, the European economy has recovered, and the Latin American countries are again creditworthy borrowers. Even then, the United States is likely to have a persistent current account deficit until the federal budget deficit is substantially reduced. As this indicates, the net debtor position of the United States will increase rapidly in the next few years.

Receipts and Payments of Investment Income

A large net debtor country on international capital account will ultimately earn less in profits, dividends, and interest on its foreign investments than foreigners earn on their in-

Table 3. Receipts and Payments of Foreign Investment Income, 1978-85

	Billions of dollars							
	1978	1979	1980	1981	1982	1983	1984	1985 ^a
Receipts of investment income	42.2	64.1	72.3	86.4	83.9	78.0	87.6	41.0
Direct investment earnings	25.2	38.2	37.1	32.5	22.3	21.3	23.1	13.1
Other private receipts	14.9	23.7	32.8	50.2	57.5	51.9	59.3	25.5
U.S. government receipts	1.8	2.9	2.6	3.7	4.1	4.8	5.2	2.3
Payments of investment income	21.7	32.9	42.1	52.4	56.1	52.6	68.5	32.9
Direct investment earnings	4.2	6.4	8.7	7.1	4.1	5.6	10.2	4.7
Other private payments	8.8	15.5	20.9	28.6	33.8	29.2	38.5	17.6
U.S. government payments	8.7	11.1	12.5	16.8	18.1	17.8	19.8	10.6
Net receipts	20.5	31.2	30.4	34.1	27.8	25.4	19.1	8.1

^a Receipts and payments in the first half of 1985, seasonally adjusted.

Source: *Survey of Current Business*, June 1985, p. 41, lines 11-13 and 25-27, and September 1985, lines 11-13 and 25-32.

vestments in that country. Under such conditions, a part of the domestic output of the country is paid to foreigners. The United States is already a net debtor on international capital account, but its earnings from foreign investments still exceed the earnings of foreigners from their investments in this country, although its net investment income has been falling rapidly. From a peak of \$34 billion in 1981, it fell to an annual rate of about \$16 billion in the first half of 1985.

Table 3 indicates the large increase and striking change in the composition of U.S. income from foreign investments in recent years. U.S. receipts increased from \$42.2 billion in 1978 to \$87.6 billion in 1984 and were at an annual rate of \$82.0 billion in the first half of 1985. The earnings of direct investment enterprises rose steadily until 1979, when they were 60 percent of U.S. foreign investment income. Their profits fell from \$38.2 billion in 1979 to \$21.3 billion in 1983 as a result of economic difficulties in other countries and the appreciation of the dollar. There has been little change in the earnings of U.S. direct investment enterprises since then, although there may be some improvement in 1985 because of the decline of the dollar.

The dramatic change in U.S. investment income has been in receipts of interest and dividends from bank loans to foreigners, foreign bonds and corporate stocks, and foreign assets of U.S. nonbanking concerns other than direct investment enterprises. These receipts increased fourfold from 1978 to 1984, when they amounted to \$59.3 billion. This was the result of a huge increase in holdings of these assets and the large rise in money market rates. Receipts of interest and dividends declined in 1983, recovered in 1984, but fell again in the first half of 1985 because of lower interest rates. Receipts of interest on U.S. reserve assets and government loans rose to \$5.2 billion in 1984, but declined in the first half of 1985.

Payments of income to foreigners on their investments in the United States increased from \$21.7 billion in 1978 to \$68.5 billion in 1984, but may be slightly less in 1985. Relatively little of the increase has been in the earnings of direct investment enterprises, which amounted to only \$10.2 billion in 1984 and may decline in 1985. That is because the growth of such investment was very slow until 1978 and much of the investment since then has been in newly established affiliates. The profits of these enterprises has followed much the same pattern as the profits of U.S. corporations from their domestic operations.

The income of foreigners from bank deposits and money market assets, corporate stocks, and corporate and other bonds (except U.S. government securities) increased from \$8.8 billion in 1978 to \$38.5 billion in 1984. This was due to the huge increase in their holdings, the rise in interest rates, and the increase in dividends. The earnings from these investments may be down slightly in 1985 because of lower interest rates. Payments of interest to foreigners — mainly foreign official agencies — on their holdings of U.S. government securities rose steadily to \$19.8 billion in 1984. This increase was due primarily to higher interest rates. Payments of interest to foreigners by the government continued to grow in the first half of 1985.

In time, the earnings of foreigners from their investments in the United States will exceed the earnings of U.S. residents from their investments abroad. This has not happened yet. One reason is that the interest rates paid by U.S. banks on deposits and other liabilities to foreigners are

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lower than the interest rates charged by U.S. banks on their loans to foreigners. Bank claims and liabilities have a higher return on capital than any other category of international investment, and U.S. loans and other claims on foreigners far exceed the deposits of foreigners and other liabilities of U.S. banks to them. Another large source of U.S. investment income is the earnings of direct investment enterprises. U.S. enterprises abroad have been long-established, and their earnings are high relative to their capital. Foreign direct investment enterprises are more recently established, and their earnings are still small relative to their capital. The earnings of foreign affiliates in this country will increase considerably as they mature. The profits of U.S. enterprises abroad will also increase, particularly if the foreign exchange value of the dollar falls, but probably not as much as the earnings of foreign affiliates in the United States. Nevertheless, within a very few years, as its net debtor position grows, the United States will be making net payments of investment income to foreigners.

"Because of the huge amount of foreign-owned assets in the United States, there is fear that a loss of confidence in the U.S. economy could lead to the flight of foreign capital and, perhaps, a debt crisis. This fear seems exaggerated when one considers the composition of foreign assets in this country."

Economic Effects of the Net Debtor Position

The emergence of the United States as a net debtor country has given rise to some troubling questions. First, there is concern that this new status will hold down the growth of output and of the standard of living in this country. Second, there is fear that a loss of confidence in the U.S. economy by foreigners could lead to a sudden withdrawal of foreign funds and precipitate a financial crisis. Finally, there is a feeling that the inflow of capital from abroad is depriving other industrial countries of the savings they need for recovery and depriving low-income countries of the resources they need for development.

Effect on the U.S. Economy

As indicated, the United States will soon have to make net payments of investment income to foreigners. These payments will be a deduction from domestic output and income. The real national income may also be adversely affected by the less favorable terms of trade that will be necessary to generate foreign exchange earnings to pay the net investment income of foreigners. These payments, however, will not hinder the growth of domestic output and employment. In 1981, when U.S. net receipts of investment income were \$34.1 billion, they contributed 1.2 percent to the gross national product and 1.5 percent to the national income. If payments of net investment income to foreigners in the future were to reach the same proportion of U.S. domestic production, the effect on the economy would be negligible. In Canada, which has about the same per capita output as the United States, net payments of investment income to foreigners amounted to 3.2 percent of the gross domestic product in 1984. There is no evidence that such payments, which have continued for generations, had any effect on the growth of output or the Canadian standard of living.

Vulnerability to Capital Flight

Because of the huge amount of foreign-owned assets in the United States, there is fear that a loss of confidence in the U.S. economy could lead to the flight of foreign capital and, perhaps, a debt crisis. This fear seems exaggerated when one considers the composition of foreign assets in this country. To begin with, official agencies hold one-fifth of all foreign assets. They are unlikely to reduce their holdings significantly except to support their currencies — that is, when the dollar is strong, not weak. Foreign direct investments account for one-fourth of the other foreign-owned assets, and they are unlikely to be liquidated. Further, about 28 percent of other foreign assets consist of stocks and bonds. Owners of these securities would have to sell them for dollars before the funds could be transferred from the United States. The assets that could be withdrawn with the least difficulty are claims on U.S. banks. As these obligations are in dollars, they could be met quickly, although precipitous withdrawals would put pressure on the banks and require the help of the monetary authorities.

Any flight from the dollar — and that could involve funds held by U.S. residents as well as foreigners — would be manifested in a huge increase in the supply of dollars in the

exchange market. The dollars would be sold to those willing to buy them with other currencies. This means that an outflow of funds from the United States would automatically be matched by an inflow of funds to this country. The dollars would be held by a different set of investors and the composition of foreign-owned assets would change, but the amount would not be reduced, except to the extent that U.S. monetary authorities or U.S. residents used their holdings of foreign currencies to buy the dollars. A large-scale flight from the dollar, however, would cause a sharp fall in its foreign exchange value. As a practical matter, such a fall is less likely to arise from a capital flight than from a reluctance of foreigners to acquire dollars at present exchange rates to the extent necessary to finance the deficit on current account.

Concern about a Fall of the Dollar

Foreign exchange rates have a pervasive effect on a country's economy. Large changes in these rates that do not reflect equivalent changes in relative prices and costs are disruptive. The sharp rise of the dollar in 1980–85 was a major cause of the huge deficit in the U.S. balance of payments on current account. A fall of the dollar would enable the United States to improve its price-competitive position in world trade and reduce its dependence on foreign capital inflow. It is sometimes said, however, that although a gradual decline of the dollar would be beneficial, a rapid fall would be harmful. This is doubtful. A gradual decline would create expectations of continued depreciation over several years, until the dollar reached what the exchange market regarded as an appropriate level. Such expectations would cause greater difficulty over a longer period than would a prompt adjustment of the rates in a more rapid fall in a shorter period.

It is commonly supposed that a fall in the foreign exchange value of the dollar would be followed by a considerable rise in interest rates. This view assumes that depreciation of the dollar would cause prices to rise and that the Federal Reserve would then tighten monetary policy; however, in the present state of the world economy, with marked weakness in the prices of basic commodities, even a large fall in the dollar would not cause a renewed inflation. It also assumes that the fall in the foreign exchange value of the dollar would have originated in a reduction in the foreign capital inflow and that the supply of loanable funds would be inadequate to meet the demand at prevailing interest rates. Most likely there would be no reduction in the net capital inflow, although the funds would come in at a lower exchange rate for the dollar. However, if the net capital inflow were reduced, it would be because the deficit on current account had been commensurately lowered. In that case, domestic output, income, and savings would have increased and, to that extent, would have decreased the dependence on foreign capital inflow to finance domestic investment.

Actually, the foreign exchange value of the dollar has been falling since the end of February, 1985. Between then and September 20, the dollar fell by an average of 15.0 percent against the currencies of the Group of Ten. On September 22, 1985, the ministers of finance and the central bank governors of the United States, the United Kingdom, France, Germany, and Japan in a joint statement said that



"Until now, the enormous capital inflow to the United States has not deprived the Western European countries of capital they need or the Latin American countries of capital they would otherwise have secured."

the high foreign exchange value of the dollar was a major cause of external imbalance, that some further orderly appreciation of the other currencies against the dollar was desirable, and that they were ready to cooperate in order to bring this about. In the ten weeks following this announcement, the dollar fell further by an average of 10.4 percent.

The fall of the dollar, although very large, has had no noticeable effect as yet on either the U.S. economy or the balance of payments. The growth of domestic production has lagged, the rise of prices has slowed further, and interest rates have continued to fall. The trade deficit was larger in the second and third quarters than in the first quarter of 1985, and there has been no significant change in the service accounts. Although the deficit on current account may begin to decline gradually in the coming year, it will remain very large for some time. As a consequence, the net debtor position of the United States will continue to increase.

Effect on Other Countries

It is sometimes said that the capital inflow from Western Europe has deprived the countries in that region of savings they need to finance domestic investment and that this is a cause of their economic stagnation. In fact, these countries have no shortage of capital. With their high unemployment and unused productive capacity, an expansion of output would generate all the savings they need for domestic investment. The outflow of capital from these countries is an

indication that their people regard the United States as an attractive place in which to invest some of their savings. Far from being the cause of slow growth and high unemployment in Western Europe, the huge trade surplus with the United States has helped to prevent even more adverse developments in output and employment.

The rise in the foreign exchange value of the dollar, as distinguished from the capital inflow, may have contributed indirectly to the economic difficulties in Western Europe. The appreciation of the dollar caused a fall in the dollar prices of basic commodities, but in terms of the Western European currencies these prices rose sharply. Although the appreciation of the dollar also caused their balance on current account to increase, most Western European countries placed more emphasis on the adverse effect on their prices than on the favorable effect on their output and employment. That is because many Europeans identify a fall in the foreign exchange value of their currencies with inflation. For this reason, their monetary authorities decided that it was necessary to raise their interest rates about as much as the rise in U.S. interest rates. This step did not stop the outflow of funds, but the tight monetary policy did hold down output and employment in Western Europe.

The United States is also criticized for having absorbed, from those countries with balance of payments surpluses, savings that the low-income countries need to finance their development. It is true that capital flows to the developing countries have fallen by 70 percent since 1982, and private capital flows have fallen even more. But that is not because the United States has absorbed the savings that would otherwise have been invested in or lent to these countries. Rather, banks and business firms in the industrial countries are no longer willing to accept the risks of increasing their loans to and investments in the developing world. Instead, the countries with balance of payments surpluses have placed more of their funds in the United States. The United States has not benefited from the diversion of the normal capital flow. It has been affected more seriously than any other industrial country by the balance of payments adjustments the developing countries have had to make. Between 1981 and 1984, the U.S. current account balance with Latin America fell by \$33 billion. This is more than the deterioration in the U.S. current account with Japan and Canada.

Until now, the enormous capital inflow to the United States has not deprived the Western European countries of capital they need or the Latin American countries of capital they would otherwise have secured. Nevertheless, it would be an inversion of economic rationality for the United States, with its large output and high incomes, to continue to absorb capital from the rest of the world. At some time in the future, the growth of output in Western Europe will resume at a rate better suited to its productive potential, and the heavily indebted Latin American countries will have made the adjustments necessary to attract foreign loans and investments again. These developments in the world economy and a lower foreign exchange value for the dollar will make it possible for the United States to reduce the current account deficit in its balance of payments and the net capital inflow that finances it. However, if the United States follows a fiscal policy that perpetuates a large budget deficit, it will inhibit the improvement in its current account, induce a renewed inflow of capital from abroad, and impede the balanced growth of the world economy.

Roger B. Porter

on How the White House Works

Roger B. Porter is professor of government and business at Harvard University. Until this fall, he served as deputy assistant to President Reagan, director of the White House Office of Policy Development, and executive secretary of the Economic Policy Council. Shortly before he left the White House, he discussed the decision-making process there with Mark Goldberg of the Review.

This was Porter's second tour of duty at the White House. He had been a White House fellow, special assistant to the president, and executive secretary of the Economic Policy Board during the Ford administration. He is a former Brookings guest scholar and the author of *Presidential Decision Making* and *The U.S.-U.S.S.R. Grain Agreement*.

Q The White House decision-making process in each administration presumably reflects the preferences of the president. How does President Reagan like to have issues presented to him for decision — on paper or in person?

My experience is that Ronald Reagan likes a dual system in which he has the benefit of a decision memorandum, which outlines on paper the options and the advantages and disadvantages associated with those options, and a meeting with the central figures in his administration who have a legitimate stake in an issue. That is, he does not rely exclusively on a paper system or on a meeting system, but combines the two.

A second characteristic of his decision-making style is that he likes to hear *directly* from the people who have a stake in an issue. That is, rather than having White House staffers serve as filters or intermediaries, he is very comfortable with getting advice directly from individuals, even if it's in the context of a meeting in which strong people are disagreeing violently with one another.

Some presidents have been uncomfortable with individuals in their administration arguing strongly and vigorously in front of them. Ronald Reagan is not uncomfortable with that at all. He has a high tolerance level for hearing competing views argued very intensely. At the same time, understandably, he is interested in officials in his administration supporting fully the decision that he reaches at the



"[President Reagan] has a high tolerance level for hearing competing views argued very intensely. At the same time, understandably, he is interested in officials in his administration supporting fully the decision that he reaches at the end of the day."

end of the day. In virtually every administration, there are questions about the role of line department and agency officials. I think because of his experience as a chief executive—as governor of California—Ronald Reagan is very sensitive to the kinds of contributions departmental officials can make. Therefore, he has tended to adopt a decision-making style that includes line department and agency officials more than some other presidents have.

Q What are the channels through which issues reach the president for decision?

There are four principal channels for advising the president on policy questions. One is through the budget process. Every year, a large number of decisions are made putting together the unified federal budget. That is a large stream of activity, and the president is very involved.

During the remainder of the year, there are three other principal channels. One is through the National Security Council, which is the forum where most major foreign policy and defense policy matters are considered. Another is the Economic Policy Council, which has responsibility for most domestic and international economic policy questions. And the third is the Domestic Policy Council, which has responsibility for domestic issues that are not primarily economic in nature—social policy questions, for instance.

There is always a question in some people's minds about whether an issue is primarily economic or primarily domestic or primarily foreign policy. Some issues don't fall into neat packages or categories. Under the current arrangements, the White House chief of staff, Donald Regan, is the individual who assigns issues when there is some question about where they should go. In practice, the system works relatively smoothly in terms of the assignment of issues to one entity or another.

I am convinced one of the reasons that it works relatively smoothly is that putting an issue in one of these channels or another does not mean that anyone is excluded. The people who have a legitimate stake in an issue will still get to at-

tend and participate, whether the forum happens to be the Economic Policy Council, the Domestic Policy Council, or the National Security Council. By having a process that is built on the principle of *inclusion*, rather than exclusion, you eliminate a lot of the jurisdictional battles that might otherwise occur.

Q Each of these councils has a regular set of members, but I take it from what you are saying that other agencies are alerted when issues they have a stake in are coming before a particular council?

All members of the cabinet are notified of what issues will be considered, when, and at what council. If they have a legitimate stake in an issue or reason to attend, then they are invited. That is to say, the meetings are not exclusively for formal members of a council.

Q Do the various councils meet on a regular schedule or do they meet as issues arise?

The councils normally meet once or twice a week. The Domestic Policy Council has been meeting on average about once a week. The Economic Policy Council has been meeting on average about twice a week. Some weeks it will meet three or four times, other weeks it will meet once or not at all. The frequency depends largely on two factors: one is the flow of issues that are coming up; and the other is the availability of key officials.

One of the features of life in government is that senior officials must often be away from Washington. Those who have the responsibility for scheduling council meetings are very sensitive to insuring that; when an issue comes up, the maximum number of people who have a legitimate stake in that issue can attend. So very frequently one will delay taking up an issue until a meeting the following week, so that a particular cabinet officer who has a very strong set of views on that issue and wants to be heard is able to attend. That's not possible in every instance because there are other action-forcing events that may preclude you from postponing consideration of an issue.



"But the overriding thrust of the system is to make sure that the president gets a full range of advice and that officials feel like the system is fair in that it does not try to advantage one advocate over another—in other words, that the process is neutral with respect to the competing views."

"He tends to focus on major issues. He gets very well prepared for big events. He does not devote large chunks of his time to minor or peripheral issues. I think that is one of the keys to his success."



But the overriding thrust of the system is to make sure that the president gets a full range of advice and that officials feel like the system is fair in that it does not try to advantage one advocate over another—in other words, that the process is neutral with respect to the competing views.

I think on the whole that cabinet department and agency officials as well as senior White House officials do feel that the system is managed in a way that is fair.

Q Presumably, the councils in some cases can resolve issues or decide that they are not worthy of the president's attention or time, and in other cases clarify issues through discussion and then send them on. Do you think that in this administration the principal role of the councils is to do the former or the latter?

One of the most important lessons for people in government, I am convinced, is to resolve issues at an appropriate level. A system will quickly become overloaded if everything is forced to the top. Indeed, it would be impossible to have all or even a fraction of all the decisions that are taken in the government forced to the top.

One of the most important functions of a council is what I like to call sifting and sorting—determining which issues should be decided at what level. We have in place a process in which a good deal of time is spent on the question, does this require the president's decision or not?

If there is a dispute between two or more departments and they are not able to resolve it to their satisfaction, then almost always the issue is taken to the president. Often, when we are able to reach closure on an issue, rather than taking the president's time in a meeting, this will be communicated to him either through a short memorandum or orally through the White House chief of staff. That insures that the president is aware of what is going on and that, if he has a different view himself, it is possible for him to say, "No, I don't agree with that." It is a system that tries to maximize the amount of information available to the president without requiring that he personally get involved in every single decision.

Q The president's time is a limited resource.

The president's time is probably the most valuable commodity in the executive branch, and it should not be used carelessly. Indeed, I think one can make a fairly successful argument that Ronald Reagan has developed a great deal of skill in the allocation of his time. He tends to focus on major issues. He gets very well prepared for big events. He does not devote large chunks of his time to minor or peripheral issues. I think that is one of the keys to his success.

Q When a decision document goes in to the president, typically who writes it?

That depends a good deal on the issue. The initial drafts are often prepared through subcabinet-level interagency groups and refined by the executive secretary of a council based on the council's discussion. These papers are then circulated to council members so that the members can see any changes that have been made.

In short, it is a process in which the people who have a legitimate stake in an issue have an opportunity to participate in the preparation of the options paper and to see it before it goes to the president. Again, the purpose is to make sure that people who are involved and engaged in an issue feel like they're having their fair say, not simply in the meetings but in the papers that go to the president.

Q What does the White House do to spot issues on the horizon?

We do basically two things. First, we have an early warning system. Each week, staff members responsible for particular policy areas submit reports that detail those things that are coming up within their areas of responsibility. We are in constant contact with departments and agencies and periodically will ask them—say, every three months or every six months—to provide us with a list of issues that they anticipate will require attention in the next three to six months.

Second, in addition to these early warning devices, we have undertaken several long-term studies that focus on issues that are less immediate but no less important in

nature. We try in these studies to look further down the road, rather than simply dealing with the most urgent request or the latest piece of legislation.

15 In your book, you indicated that a problem with the Ford administration's decision-making process — which you generally praised and found worked very well — was that there wasn't a systematic way of gathering intelligence on the domestic political impact of issues that were coming before the president. Is there that kind of system in this administration?

This administration has made a much more conscious effort to include those kinds of considerations in preparing the materials that go to the president. That should not be interpreted as suggesting that the decisions the president makes are highly political in nature. In fact, one of the things that has impressed me most about Ronald Reagan is his relative lack of interest in political or partisan considerations. He is deeply committed, I am convinced after having spent a lot of time around him, to doing what he views as the right thing. I have been amazed at how unsuccessful people are when they urge a particular course of action on the president on the basis that it is politically wise or expedient.

Nonetheless, it is important for a president in making a decision to have information regarding how the Congress and outside interest groups and the public at large will likely react to alternative courses of action. He needs to be aware of this so that he fully understands the consequences of the choices that he favors.

We have consistently sought to include in our policy deliberations individuals who have responsibilities in these areas, so that we can make sure their contributions get factored in at the same time that the substantive arguments are being made.

16 Is there in your judgment an ideal process that would serve well presidents of different parties, different decision-making styles, and so on? Or should the process be adapted to each president?

There is something almost a bit romantic about the no-

tion that we can discover or settle upon an ideal process that will work equally well under all circumstances and for all people. It is part of our American attraction to structures and systems — our sense that if we could just get the structure right, policy would be optimum.

Government doesn't come in those neat packages. One of the things that is both interesting and challenging about advising presidents is that the type of advisory system that is most useful is one with which the chief executive is comfortable. Therefore, there will always be some variations to meet the particular preferences, interests, and styles of different chief executives.

There are, however, some general rules that are applicable to a number of different styles and that I think are appropriate. Perhaps key among these is that the most important thing to understand about an advisory system is its objective.

Many people want to have an advisory system whose objective is wise decisions. In my view, that is an unattainable goal. Wise decisions are based on wise judgment. Whenever you have individuals exercising their judgment, sometimes that judgment is going to be wise and sometimes it is going to be unwise. There is nothing an advisory system can do about that.

What an advisory system *can* do is to provide for informed decisions. That should be its prime objective. A chief executive has a good advisory system when it gives him the information that he needs to know about an issue and about the range of viable choices or alternatives he faces, and when it fully examines and explains to him in terms he can understand the advantages and disadvantages associated with each of those alternatives.

When a decision-maker has that array of information and advice available to him, he will then be making an informed decision, and naturally I believe that you have a much better prospect of making wise decisions if you're making informed decisions. There are many instances when unwise decisions have been made because they were not fully informed.

I consider it an important objective to have presidents making informed decisions. And experience has shown that to the extent that you include, rather than exclude, officials, you are more likely to have informed decisions. That doesn't mean that everyone in the government who would like to be in a meeting needs to be there or ought to be there, but it suggests that systems that provide for a very limited number of people to have the principal responsibility for advising the president often leave out important parts of the puzzle.

If what one is about is drawing a map of substantive and political reality for a president, so that he is fully aware of what his real choices are, one often needs a large number of hands to draw that map — and it is likely to be most detailed and most accurate when all those who have a legitimate stake in an issue are included.

To the extent that important points of view or sets of considerations are excluded, then you have some bare patches on that map, and that is when you can make mistakes.

Ronald Reagan as president instinctively seems to recognize that and reaches out and includes a large number of officials in advising him on the key issues. I think that is one of the reasons for his success as a decision-maker.

"I have been amazed at how unsuccessful people are when they urge a particular course of action on the president on the basis that it is politically wise or expedient."

Briefing on the Summit

BROOKINGS held a special briefing for reporters in advance of the summit meeting between President Reagan and Soviet leader Mikhail Gorbachev. The briefing was conducted by John D. Steinbruner, director of the Brookings Foreign Policy Studies program, and Helmut Sonnenfeldt, a guest scholar at Brookings and former counselor of the U.S. Department of State.



Helmut Sonnenfeldt and John D. Steinbruner.



Board Hears Scowcroft and Honors Stein

LIEUTENANT General Brent Scowcroft, USAF (retired), spoke at the Brookings board of trustees dinner in November. He provided a historical perspective on current issues of U.S. national security policy. His audience included guests from the public policy community and representatives of corporations that provide support to Brookings, as well as members of the Institution's board and staff.

The board honored Sydney Stein, Jr., by naming its meeting room after him. Stein has been a Brookings trustee for 25 years and a generous benefactor of the Institution. He has served as vice chairman of the board and member of the executive committee, chairman of the development committee, and member of the finance committee.



Sydney Stein, Jr., and A. Lee Fritschler,
director of the Center for Public Policy
Education at Brookings.

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Lieutenant General Brent Scowcroft,
USAF (retired).



Above left: Trustee Donald F. McHenry,
university research professor of
diplomacy and international affairs
at Georgetown University, and John
Hechinger, president of Hechinger Co.

Above right: Trustee James D. Robinson,
III, chairman of the board of American
Express Co., and A.W. Clausen, president
of the World Bank.



Honorary trustee Gerard C. Smith,
president of The Consultants International
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of the board of The Washington Post
Company; and Lloyd N. Cutler, partner,
Wilmer, Cutler & Pickering.

The Dynamics of Deregulation

BETWEEN 1975 and 1980, several well-entrenched regimes of government regulation were largely dismantled despite strong opposition from the industries that they protected. According to Martha Derthick and Paul J. Quirk, policy change was achieved through the politics of ideas: the fusion of expert analysis, from economists who said that regulation was inefficient, with public opinion, which viewed deregulation as a way of fighting inflation and big government.

Deregulation demonstrates that the U.S. political system has a greater capacity to transcend narrow interests than has generally been acknowledged, write Derthick and Quirk in *The Politics of Deregulation*. Their analysis centers on three cases of successful deregulation: the airline, trucking, and telecommunications industries. In each instance, Congress resisted pressures from powerful and well-organized interests (the regulated industries and unions) and acted on behalf of the poorly organized consumers of the services involved.

Derthick and Quirk find that deregulation occurred for five principal reasons:

- Elite opinion converged in support of reform. Economists, who said that the costs of economic regulation far outweighed the benefits, were joined by policy research organizations and officials in federal executive agencies. Political leaders (in particular, presidents Ford and Carter), who were seeking cures for inflation and responses to the public's concerns about government intervention, then began to advocate deregulation. Procompetitive reform proved to have broad political appeal, engaging both liberals and conservatives.

- Key officeholders took the initiative. Presidents, commission chairmen, and congressional committee and subcommittee leaders generally advocated reform. Such leaders are especially induced or constrained to serve broad interests, Derthick and Quirk argue. Deregulation was a well-developed prescription that leaders perceived would be successful and for which there was room on the agenda.

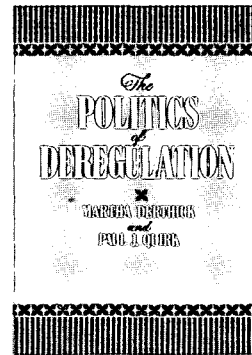
- Congress did not have to act in order for deregulation to occur. This circumstance was crucial, the authors write. Regulatory commissions acted themselves. Where they failed to institute reforms, courts were available as an alternative instrument; for example, it was a court that required long-distance telephone service to become competitive. The commissions were both very vulnerable to external influence and exceptionally endowed by statute with authority to act. Had they not been, they would have been less capable of forcing Congress's hand, according to Derthick and Quirk. The broad, flexible grants of statutory authority enjoyed by the commissions emboldened reform-oriented chairmen to reverse long-standing practices.

- Yet Congress did act. In the airline and trucking cases, Congress passed strongly or radically procompetitive bills. Even in the face of intense interest group opposition, majorities in committees and on the floors of both houses proved willing to endorse reform, persuaded by committee leaders, the administration, and the commissions. Reform advocates could provide simple and vivid evidence on the issues, answer questions about their proposals' effects on consumers, and make a rhetorical connection between deregulation and larger concerns of the public. When the opposition of industries waned as a result of commission action, Congress endorsed deregulation very strongly.

- Affected industries had only a limited ability to protect their interests through political action. They were put at a disadvantage when steps by commissions and courts toward deregulation proved economically unsettling, diminished regulatory protection, and threatened to go even further—all of which suggested the need for compromise in order to pass legislation and restore stability. The indus-

The Politics of Deregulation

By Martha Derthick and Paul J. Quirk
\$10.95 paper; \$28.95 cloth.



tries, although mobilized in opposition, had difficulty converting their economic resources effectively to political use. Their capabilities for political action suffered from lack of coordination and unity and the failure of firms to sustain an energetic political effort.

According to Derthick and Quirk, these cases demonstrate the role that disinterested economic analysis can play in the formation of public policy. "If economists had not made the case for procompetitive deregulation," they write, "it would not have occurred—at least not on the scale the nation has witnessed." The authors recommend an increase in governmental capacity to anticipate policy debate and to conduct, or at least plan, pertinent research before it is needed. This increased capacity could be built up on one or more of the congressional staff agencies—the Congressional Budget Office, Office of Technology Assessment, and Congressional Research Service.

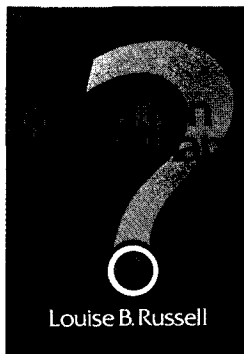
Derthick, professor of government and foreign affairs at the University of Virginia, was previously director of the Brookings Governmental Studies program. Quirk, now an assistant professor of political science at the University of Pennsylvania, was formerly a research associate in the program.

Preventive Measures

Is Prevention Better Than Cure?

By Louise B. Russell

\$9.95 paper; \$26.95 cloth.



ADVANCES in prevention—new vaccines, screening techniques, and recent discoveries about the benefits of certain changes in lifestyle—have spurred new interest in preventive measures as a way to maintain health and cut medical bills. But while prevention has great potential for improving health, it is not without risks or costs, according to a new study by Louise B. Russell.

In *Is Prevention Better Than Cure?*, Russell, a senior fellow in the Brookings Economic Studies program, shows that preventive measures are not as simple as often predicted. And at a time when policymakers are searching for ways to control spiraling national health care costs, she finds that preventive measures rarely reduce medical expenditures. In fact, contrary to the popular view, prevention usually adds to those expenditures, Russell finds. Consumers must decide when the health gain is worth higher costs.

The smallpox vaccine illustrates how the risks and benefits of a preventive measure can change over time, requiring reevaluation. In the almost 200 years since the vaccine was developed, debate about it has flared up again and again, Russell notes. The early vaccine involved substantial risks, but offered a good chance of protection against a disease that was serious and often fatal. The controversies of the 19th century continued into the 20th, even though vaccination was made safer, in part because the disease took a somewhat milder form. By the middle of the 20th century, however, vaccination was nearly universal in the United States and smallpox had disappeared not only from the United States, but from many other developed countries as well. The debate then turned to whether the risks of the vaccine, small as they were, were justifiable when the risks of contracting the disease had become almost nonexistent. The issue was not resolved until the campaign to eradicate smallpox worldwide neared completion, leading the United States to discontinue its policy of routine vaccination of children.

Screening and treatment for hypertension (high blood pressure) is a good example of why prevention is often more expensive than it appears at first glance. The screening test is cheap, and treatment for the consequences of high blood pressure—stroke and heart disease—is expensive. But that simple comparison ignores many steps necessary to prevent hypertension and the large numbers of people and long periods of time for which prevention is necessary, according to Russell. The current recommendation is that all adults should have their blood pressure checked every year or two; thus the cost of testing the population is substantial even though the cost per test is small. Anyone whose pressure is high

on the first test must be retested several times over weeks or months to be sure that the first result was not a fluke. If the diagnosis is confirmed, the patient must be evaluated more thoroughly before treatment is prescribed — another expense. Treatment usually involves drugs, which the patient must take regularly for many years to keep blood pressure under control; the cost of these drugs averages several hundred dollars a year. Thus, careful evaluation shows that the cumulative costs of treating hypertension are far larger than the savings.

While some preventive measures may reduce costs elsewhere in the economy to compensate for higher medical costs, few studies have examined this possibility carefully, Russell says. Further, some measures may add to costs elsewhere. This is particularly likely to be true of changes in lifestyle, which involve real resources, such as people's time, that are often omitted from evaluations because no one pays for them in cash. Exercise is a notable example, and Russell discusses not only its benefits, but its hidden costs. "The case of lifestyle underscores the point that the principal consideration in thinking about an investment in health is total costs, not the cost in any particular sector of the economy," she writes. "The sensible approach is to look at the total costs required by a preventive measure, wherever those costs occur, and to compare them with the improvements in health they produce."

The New Reality of Realty

SINCE 1979, a revolution in real estate finance has profoundly affected the institutions involved, how much and what kinds of capital they provide, and events in real estate markets across the nation. These impacts will probably persist well into the 1990s, according to Anthony Downs, a senior fellow in the Brookings Economic Studies program. In his new book, *The Revolution in Real Estate Finance*, Downs notes that real estate is both the largest and the most widely distributed form of wealth in the nation, so that the changes that have taken place are important to nearly every American household.

The revolution has had three especially important effects, writes Downs. They are: (1) housing's loss of its once-favored position in U.S. capital markets; (2) a strong bias in those markets toward the financing of non-residential real estate; and (3) an imbalance between the risks and rewards for managers of real estate-oriented financial institutions, which has created turmoil among those institutions and driven many close to bankruptcy.

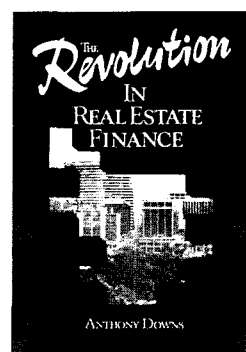
A combination of inflation and financial deregulation has reduced the social priority accorded to housing by federal policy-makers. This has generated a widely recognized housing affordability problem, especially among potential first-time homebuyers. Downs's analysis of this problem takes into account the *time dimension* of housing affordability — that is, the ability of households to improve their housing purchasing power by saving before they buy. He argues that potential first-time homebuyers are more able to cope with their housing needs than analysts have realized, except in a few high-cost markets. Hence, no federal assistance should be extended to first-time buyers, especially since low-income renters have far more pressing needs for housing aid.

The bias in capital markets arises from benefits provided by federal policies to financial institutions specializing in real estate investment. These benefits are federal deposit insurance for thrifts (savings and loans and mutual savings banks) and commercial banks, and tax breaks for syndicators. Because these institutions can raise capital from savers at lower costs than their competitors, they have been swamped with funds, especially since 1983, when deregulation removed ceilings on their interest rates.

Syndicators must invest their funds in real estate, savings and loan have always done so and are under federal regulatory pressure to continue, and banks

The Revolution in Real Estate Finance

By Anthony Downs
\$11.95 paper; \$31.95 cloth.



are attracted to construction loans to absorb their funds. Freedom from import competition has also encouraged heavy investment in U.S. real estate by both domestic and foreign pension funds.

As a result of these factors, there has been a flood of capital into non-residential real estate markets. Large surpluses of space have arisen, particularly of office space and hotels. Yet new building of similar space is continuing. Even proposed tax reforms would not fully offset this bias.

The third key effect has been turmoil among real estate-oriented financial institutions, generated by an imbalance between the risks and rewards of investing in real properties. Partial deregulation of financial institutions has both allowed thrifts to make a wider range of investments than ever before, and created incentives for them to do so. The faster they expand deposits by offering high savings rates, the greater their potential profits from reinvesting those deposits. But to get what appear to be high returns, they must often invest in risky projects. This includes undertaking ventures in which they have little or no experience. Yet retention of federal deposit insurance eliminates much of the risk of depositors that will put their money into such institutions. The resulting imbalance of risks and rewards has generated reckless expansion by a few thrifts that could endanger the solvency of the Federal Savings and Loan Insurance Corporation.

Increasing insurance premiums for risk-taking thrifts and otherwise making them more sensitive to the market responses to their behavior are desirable steps, Downs writes, but these are only partial remedies. As long as the nation retains federal deposit insurance, which it is sure to do, there is no way to remove fully the imbalance between risks and rewards without re-regulating the industry.

The revolution itself has arisen because of five key factors: (1) shifts in the attitudes of capital suppliers (lenders and equity investors) toward inflation, (2) housing's loss of its favored credit-market position, (3) radical changes in federal fiscal and monetary policies, (4) partial deregulation of financial institutions and (5) technological improvements in funds transfer and communications.

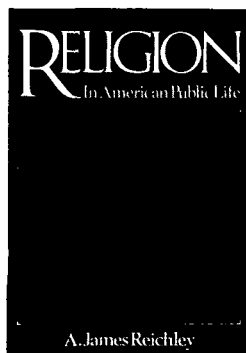
Two of the revolution's key causes may change over time, Downs says. Monetary policy has already shifted, and lender attitudes toward inflation are starting to do so. But the other three causes are permanent. Their continuance, plus the persistence of fiscal policies involving large federal deficits that keep nominal interest rates relatively high, almost guarantee that most of the revolution's effects will dominate real estate markets for many years.

Faith in the Political System

Religion in American Public Life

By A. James Reichley

\$11.95 paper; \$31.95 cloth.



CHANGES in political behavior among some religious groups and church leaderships are significantly affecting the balance of national politics, according to Brookings senior fellow A. James Reichley. In *Religion in American Public Life*, he concludes that these changes may over the long term undermine the traditional role of religion in nurturing moral and social values.

The largest political change has occurred among white evangelical Protestants, he reports, a group that has traditionally had relatively low registration and voting rates and has tended to favor the Democratic party, reflecting both the group's concentration in the South and its relatively low economic status. Since the late 1970s, he writes, white evangelicals have become among the most politically active of all religious groups and have heavily supported conservative Republicans. In 1980, evangelicals, who four years before had favored Jimmy Carter, gave 60 percent of their vote to Ronald Reagan. In 1984, evangelical voters cast 80 percent of their ballots for Reagan and about 75 percent for Republican congressional candidates.

The shift in voting patterns among white evangelicals was due to several factors, Reichley finds, including the organizing activities of charismatic religious leaders like Jerry Falwell and Pat Robertson, and the sense among evangelicals

that traditional morality was being undermined by "secular humanists" who had gained control of national politics and the federal courts. Evangelicals became convinced that to turn back the challenge to traditional morality, they would have to abandon political passivity and back candidates who promised to carry out their social agenda.

Reichley finds that Roman Catholics, who have supported the Democratic party through most of American history, have also changed their behavior, giving Reagan about 55 percent of their vote in 1984. A similar percentage of Catholics voted for Democratic candidates for the House of Representatives — a proportion far below past levels of support. The abortion issue, survey evidence shows, decisively influences about 10 percent of Catholic voters, who are moving toward the Republican party because it is seen as being more in agreement with the right-to-life movement. That issue has also had the even more profound effect of dissolving the connection that most Catholics had seen between being a good Catholic and supporting the Democratic party.

Catholics remain more liberal than the electorate as a whole on economic and foreign policy issues, and most liberal Catholics continue to vote Democratic, he says. But the growing percentage of Catholics who are economic and foreign policy conservatives now feel free to vote Republican, a fact that deprives the Democrats of a reliable block of support in many industrial states.

Black Protestants, among whom church leaders have always had major political impact, continue to vote heavily Democratic, he finds. But the black church leadership has indicated a willingness to pursue black interests outside the established structure of the Democratic party.

Jews also continue to give majority support to the Democrats, but by substantially lower margins and with less commitment than from the 1930s to the 1970s. On the basis of surveys and interviews with Jewish leaders, Reichley concludes that many Jews would support a moderate conservative party, but are offended by the growing influence of Christian fundamentalists in the Republican party.

The mainline Protestant denominations have provided the mass base for the Republican party since the Civil War. In recent years, Reichley writes, the leaders of those denominations have moved well to the left of the prevailing sentiments in both major parties. Since the start of the Reagan presidency, offices representing the mainline denominations in Washington have voiced opposition to the administration's positions on a wide range of economic, social, and foreign policy issues. Electoral behavior and surveys of their own members conducted by some of these denominations show that majorities among the laities remain politically conservative. This political split between church leaderships and laities, Reichley finds, is contributing to internal crises within several mainline denominations.

Reichley shows that churches have been active in secular politics throughout American history, having played important roles in such causes as the abolition of slavery, the enactment of prohibition, women's suffrage, and the civil rights movement of the 1960s. The First Amendment, reflecting American pluralism, prohibits the sponsorship by government of any particular religion or of religion in general, but encourages free exercise of religion, much as it encourages free speech and a free press, Reichley notes. He adds that the amendment "is no more neutral on the general value of religion than it is on the general value of a free exchange of ideas or an independent press."

Reichley argues that the most important social function of the churches, distinct from their more purely religious functions, is breeding and nurturing democratic values. This role is not incompatible with the pursuit of particular social goals, such as strengthening family life, helping the poor, or promoting disarmament. But if the churches become too involved in the details of electoral or legislative politics, they risk loss of moral legitimacy among many of their members. Reichley suggests that to avoid this danger, churches should concentrate on moral objectives rather than on legislative details that turn on technical or empirical questions, consider the probable outcomes of policies as well as the immediate moral gratification they may bring, avoid direct involvement in election campaigns or the exchange of political favors, and resist the identification of religion with particular social or economic ideologies.



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